Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

RAIZY LEVITIN, *et al.*,

Petitioners,

vs.

PAINEWEBBER, INC.,

Respondent.

LOUIS G. BISSELL, JR.,

Petitioner,

vs.

MERRILL LYNCH & COMPANY, INC., and
MERRILL LYNCH PIERCE, FENNER & SMITH, INC.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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102 pp

QUESTION PRESENTED

Section 9-207(2)(c) of the Uniform Commercial Code provides that:

> Unless otherwise agreed, when collateral is in the secured party's possession *** the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation.

In dismissing all the claims asserted in this litigation, the court below held, *inter alia*, that § 9-207(2)(c) was *impliedly* preempted by federal securities law.

In holding that § 9-207(2)(c) of the UCC (of which identical versions have been enacted in all 50 states) was impliedly preempted by federal securities law, notwithstanding (i) the absence of any conflict between § 9-207(2)(c) and any specific provision of the federal securities laws, and (ii), the SEC's express pronouncement that it does not regulate payment of interest to customers on their collateral(as well as a similar pronouncement by the Federal Reserve Board), did the court below ignore the preemption principles established by this Court?

PARENT COMPANIES AND NON-WHOLLY OWNED SUBSIDIARIES (RULE 29.6)

Both petitioners are individual, natural persons.

TABLE OF CONTENTS

QUESTION PRESENTED i

PARENT COMPANIES AND NON-WHOLLY OWNED SUBSIDIARIES (RULE 29.6) ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES vi

OPINIONS BELOW 1

JURISDICTION 1

STATUTORY PROVISIONS INVOLVED 1

STATEMENT OF THE FACTS 2

REASONS FOR GRANTING THE WRIT 4

ARGUMENT 7

A. UCC AND FEDERAL SECURITIES LAWS 7

B. THE IMPLIED PREEMPTION RULING . 10

CONCLUSION 15

APPENDIX

Appendix A - Opinion of The United States Court of Appeals For The Second Circuit In Raizy Levitin v. PaineWebber, Inc. Dated And Decided September 29, 1998 . . . . . 1a

Appendix B - Opinion of The United States Court of Appeals For The Second Circuit In Louis Bissell, Jr. v. Merrill Lynch & Company, Inc., et al. Dated And Decided September 29, 1998 . . . . . 22a

Appendix C - Opinion And Order Of The United States District Court For The Southern District Of New York In Louis G. Bissell, Jr. v. Merrill Lynch & Co., Inc. et al. Dated August 14, 1996 . . . . . 24a

Appendix D - Opinion Of The United States District Court For The Southern District Of New York In In Raizy Levitin v. PaineWebber, Inc. Dated July 9, 1996 . . . . . 50a

Appendix E - Section 9-207 of New York's Uniform Commercial Code 63a

Appendix F - Pertinent Excerpts from Department of Treasury Regulations Governing Book-entry Treasury Bonds, Notes and Bills. 61 FR 43626-7 (August 23, 1996) 65a

Appendix G - Pertinent Excerpts from the Market Reform Act of 1990, Report of the Senate Committee on Banking, Housing and Urban

Affairs. S. Rep. No. 101-300, 101st Congress,
2d Sess., at P. 64 (May 22, 1990) 66a

Appendix H - Pertinent Excerpts From
136 Cong. Rec. S13771-02, S13777 (Sept. 25, 1990) . 71a

Appendix I - July 12, 1979 SEC No Action Letter
Re Interest To Clients On Short Sales 74a

Appendix J - December 2, 1994 Letter From
Federal Reserve Board To Plaintiffs' Counsel. 76a

TABLE OF AUTHORITIES

CASES

Barnett Bank v. Nelson,
517 U.S. 25 (1996) 7

Bissell v. Merrill Lynch & Co., Inc.,
937 F. Supp. 237 (S.D.N.Y. 1996)
aff'd, 157 F.3d 138 (2d Cir. 1998) . . . . . *passim*

Bissell v. Merrill Lynch & Co., Inc.,
157 F.3d 138 (2d Cir. 1998) . . . . . *passim*

Chasins v. Smith, Barney & Co.,
438 F.2d 1167 (2d Cir. 1970) 13

De Buono v. NYSA - ILA Medical and Clinical Services Fund,
520 U.S. 806, 117 S. Ct. 1747 (1997) 9

Jones v. Rath Packing Co.,
430 U.S. 519 (1977) 8

Levitin v. PaineWebber, Inc.,
933 F. Supp. 325 (S.D.N.Y. 1996)
aff'd, 159 F.3d 698 (2d Cir. 1998) . . . . . *passim*

Levitin v. PaineWebber, Inc.,
159 F.3d 698 (2d Cir. 1998) . . . . . *passim*

Madsen v. Prudential Fed. Savings & Loan Ass'n,
558 P.2d 1337 (Utah 1977) 4

Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,
135 F.3d 266 (3d Cir. 1998) 13

Phillips v. Washington Legal Foundation,
118 S. Ct. 1925 (1998) 4

SEC v. Lehman Brothers, Inc.,
157 F.3d 2 (1st Cir. 1998) . . . . . *passim*

STATUTES, RULES AND REGULATIONS

15 U.S.C. § 78 3

28 U.S.C. § 1254 1

28 U.S.C. § 1331 3

28 U.S.C. § 1652 7
8

28 U.S.C. § 1367 3

Uniform Commercial Code § 9-207 . . . . . *passim*

U.S. Supreme Court Rule 12.4 1

MISCELLANEOUS

Singer, SEC No Action Letter,
1979 WL 14184 (July 12, 1979) 14

Rules and Regulations Department of the Treasury Fiscal Service, 31 CFR Part 357, Regulations Governing Book-Entry Treasury Bonds, Notes and Bills, 61 FR 43626-01, 1996 WL 475279 (Aug. 23, 1996) 9

Report of Senate Committee on Banking, Housing and Urban Affairs P.L. 101-432, The Market Reform Act of 1990, Sen Rep. No. 101-300, 1990 WL 259302 (May 22, 1990) 9
10

Securities Market Reform Act, 136 Cong. Rec., S13771-02, 1990 WL 359769 (Sept. 25, 1990) 10

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Raizy Levitin and Louis Bissell, Jr., respectfully petition for a writ of certiorari to review the judgments of the United States Court of Appeals for the Second Circuit in these cases.

OPINIONS BELOW

The opinions of the court of appeals, see appendix ("App." p. 1a-23a), are reported at 159 F.3d 698 and 157 F.3d 138. The opinions of the district court (App. pp. 24a-62a) are reported at 937 F. Supp. 237 (S.D.N.Y. 1996) and 923 F. Supp. 325 (S.D.N.Y. 1996).

JURISDICTION

The court of appeals entered its judgments on September 29, 1998. (App. p. 1a-23a.) The jurisdiction of this Court is invoked under 28 U.S.C. §1254. A single petition is filed pursuant to this Court's Rule 12.4.

STATUTORY PROVISIONS INVOLVED

The text of UCC § 9-207 (which exists in all fifty states) is reprinted in the appendix at p. 63a. The relevant portion of the section is also printed above at p. i and below at p.4.

STATEMENT OF THE FACTS

The relevant facts are both few and uncomplicated. The *Levitin* and *Bissell* actions challenge the interest capturing practices of the respondent brokerage firms in connection with "short sales". In a short sale, a customer invests in the belief that the price of a particular stock will decline in price. The customer sells stock that she does not own, borrows that stock from the broker-dealer for delivery, receives the sale proceeds, and she later "covers" the short sale by buying identical stock and restoring it to the broker-dealer.

Brokers demand and are entitled to collateral with respect to securities that they lend. The collateral generally includes the sale proceeds, which the broker ordinarily holds until the short sale is covered. The customer may also be required to post additional collateral in order to satisfy federal "margin" requirements and the margin requirements of the New York Stock Exchange (See App. p. 4a). But no Federal Reserve Board regulation, or SEC or Stock Exchange rule either prohibits or mandates payment of interest on customer credit balances. As the court below twice recognized, the SEC's consistent position has been that whether such interest is to be paid "is a matter of negotiation between the customer and the broker-dealer" (App. p. 5a and p. 10a n.7).

Respondents profit in a wide variety of ways from their possession of the customers' short sale collateral, but, in violation of UCC § 9-207(2)(c), keep these profits for themselves without disclosure to, let alone the agreement of, their customers. The *Levitin* and *Bissell* complaints alleged

that respondents' conduct violates § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and SEC rules 10b-5, 10b-10, and 10b-16 thereunder, as well as various provisions of New York state law, including § 9-207(2)(c) of New York's UCC. District Court jurisdiction was invoked under 28 USC § 1331, pursuant to § 27 of the Exchange Act, 15 USC § 78aa, and 28 U.S.C. § 1367.

The district court dismissed *Levitin* (App. p. 50a-62a) solely on the ground that Levitin's complaint failed to satisfy 10(b)'s "in connection with the purchase or sale of any security" requirement (App. pp. 57a, 60a and 61a). Shortly thereafter, *Bissell* concurred with the "analysis of the 'in connection with' requirement in *Levitin*, and reach[ed] the same conclusion." (App. p. 32a)[1]

In affirming dismissal in *Levitin*, the Second Circuit did not address the "in connection with" issue that had served as the linchpin of the district court opinions but which the SEC had itself challenged in the court of appeals. Instead, the court rejected the 10(b) claim because, despite explicit allegations that they did not know of respondents'

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[1] The *Bissell* court added several points of no significance here: The statute of limitations had expired for certain 10(b)-16(a) claims, (b) plaintiff did not allege the defendants failed to provide the requisite 10b-16 notice procedures, and (c) 10b-16 does not require the disclosures sought (App. pp. 36a-40a). The decision also found that no fiduciary duty existed, that no implied covenant had been breached, and that the UCC claims should fall because the parties had "otherwise agreed" to Merrill Lynch's retention of the interest (App. pp. 40a-49a). Both *Levitin* and *Bissell* appeared to presume that the federal securities laws had not preempted the apposite UCC provisions.

conduct, petitioners were charged with such knowledge as a matter of law: a "reasonable investor knows . . . that a brokerage can earn profits from funds posted with it as security for short sale transactions" (App. p. 8a). The court held that UCC § 9-207 is preempted by federal securities laws. It so held notwithstanding (i) the absence of any federal statute rule or regulation governing ownership of such profits, (ii) the absence of any conflict between § 9-207(2)(c) and any specific provision of the federal securities laws, and (iii) the SEC's express pronouncement that it does not regulate this aspect of short sales. *Bissell* was decided upon the authority of *Levitin*.

This petition seeks review of the preemption holding.

REASONS FOR GRANTING THE WRIT

"The rule that 'interest follows principal' has been established under English common law since at least the mid-1700's . . .Not surprisingly, this rule has become firmly embedded in the common law of the various States". *Phillips v. Washington Legal Foundation*, 118 S.Ct. 1925, 1930 (1998). Indeed, the principle is said to extend back through two millennia – to the legendary laws of Manu and Hammurabi. *See Madsen v. Prudential Fed. Savings & Loan Ass'n*, 558 P.2d 1337, 1340 (Utah 1977). Article 9-207(2)(c) of the UCC substantiates that rule in all 50 states, including New York: "*Unless otherwise agreed*, when collateral is in the secured party's possession *** the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in

reduction of the secured obligation" (App. p. 63a)(emphasis added).

Respondents retain the profits on their customers' collateral in short sales. They do this without the knowledge, let alone the agreement, of their customers. The complaints in this litigation alleged, *inter alia*, that respondents' conduct violates § 9-207(2)(c). The court held, however, that § 9-207(2)(c) was impliedly preempted by federal securities law. *It did so even though it could point to no conflict with any specific provision of federal law;* indeed it cited the SEC's express pronouncement that it does not regulate this aspect of short sales (App. p. 5a).

No one disputes that Congress, or the SEC acting under Congressionally conferred authority, could regulate interest payments on short sales and thereby preempt or displace state law. "If there were conflict between [federal securities law and the UCC], the latter would give way . . ." *SEC v. Lehman Brothers, Inc.*, 157 F.3d 2,8 (1st Cir. 1998). But here, as in *Lehman Brothers*, "[t]here is no such conflict." *Ibid*. As the court below recognized, no express conflict exists. Nor is there an "implied" preemption because § 9-207(2)(c) does not impede any federal policy. In fact, as the court of appeals acknowledged, the SEC explicitly recognizes that payment of interest is a matter for negotiation between brokers and customers. UCC § 9-207(2)(c) implements that policy. It simply establishes a "default rule" when there is no existing agreement between the parties. Despite the federal policy of leaving interest payment to negotiation, the court below held that this is not a matter for negotiation, but is in fact governed by a silent federal securities law that displaces otherwise controlling

state law in favor of the secretive practice of brokers. Nothing in the federal securities laws mandates such a result.

None of the three reasons provided by the court remotely shows that § 9-207(2)(c)'s default rule threatens any federal policy. The court first points to the "extensive" federal regulation of customer funds and short selling (App. p. 14a-16a). But that cuts against a preemption conclusion because, as the SEC announced, payment of interest is *not* a matter within the compass of the federal regulation. The court's second point seeks to deflect the force of the fact that no conflict exists between federal and state law by claiming that petitioners' argument would permit various UCC provisions to trump SEC rules. This claim is simply mystifying. Petitioners nowhere made such a contention. Wherever the SEC has actually regulated, state law will be displaced whenever it conflicts with federal law. *SEC v. Lehman Brothers, Inc.*, *supra*. Furthermore, the only "conflict" between laws that the court identified -- that state laws requiring segregation of the interest would intrude upon the federal regulatory scheme which allows commingling -- simply has no bearing here. UCC § 9-207 does not require segregation. To the contrary, it expressly permits commingling. *See* § 9-207(2)(d). If the state law did not, federal law would prevail (*see Lehman Brothers*, *supra*), and petitioners have never contended otherwise. The court's final point, that respondents practices have "existed most of this century," is an "easement" theory of wrongdoing: violations of applicable law can be ignored if the party has a long history of so doing.

ARGUMENT

Barnett Bank v. Nelson, 517 U.S. 25, 30-31 (1996), and other decisions of the Court establish that implied federal preemption exists only when (1) the federal statute creates a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for states to supplement it", or (2) federal law is in "irreconcilable conflict" with state law; or (3) compliance with both statutes is a "physical impossibility"; or finally, (4) when state law stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress. None of these circumstances obtains here. Far from it. The UCC and the federal securities laws have a long history of interaction and mutual coexistence. And § 9-207(2)(c) not only contradicts no federal policy, it reinforces the articulated federal policy of leaving the payment of interest to negotiation between brokers and their customers.

A. UCC AND FEDERAL SECURITIES LAWS

The court began its preemption analysis by stating that preemption of § 9-207(2)(c) "does little harm to federalism . . . [because] [w]e are not dealing with a state statute that was consciously intended to regulate the transactions in question" (App. p. 13a). What legal theory can this possibly reflect? Such reasoning is seriously at variance with the fundamental background premise of our entire constitutional order, confirmed by the Rules of Decision Act, 28 U.S.C. § 1652, namely, that state law

governs unless displaced by valid national authority.[2] What is more, as the court below acknowledged, numerous examples exist where the UCC has unquestioned application to securities that are also subject to federal securities regulation (*see* App. p. 13a). Thus, as the First Circuit appropriately said in *Lehman Brothers, supra* at 5:

> New York law is a sound starting point because in this instance, as in most commercial transactions, state law provides the matrix of background rules and is ordinarily displaced, if at all, only by conflicting or field-occupying provisions of federal statutory law, or occasionally by federal common law. Here, the margin account agreement relied on by Lehman Brothers for its priority is expressly governed by New York law. The parties agree that save as federal law may dictate otherwise, Lehman Brothers' rights to the proceeds vis-a-vis the SEC are controlled by article 8 N.Y.U.C.C. §8-301 *et seq*.

Commercial transactions in securities is a field "traditionally occupied by the States". *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977). Accordingly, respondents "bear the considerable burden of overcoming the starting presumption

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[2] That statute provides: "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

that Congress does not intend to supplant state law." *De Buono v. NYSA - ILA Medical and Clinical Services Fund*, 520 U.S. 806, 117 S. Ct. 1747, 1752 (1997).

Wholly apart from the pervasive historic interaction between federal securities law and the UCC, considerable additional evidence shows that there is no general Congressional intention to displace the UCC in the securities area. For example, in the Department of Treasury's Rules and Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills, 61 FR 43626 (Aug. 23, 1996), the Department made clear that its authority to displace the UCC is "limited", and the that federal regulation of securities looks to various UCC provisions. *See* 61 FR at 43626-7 (App. p. 65a). Similarly, the legislative history of the Market Reform Act of 1990, enacted in the wake of the October 1987 stock market crash in order to "harmoniz[e] the state laws governing the transfer and pledge of securities", reflects a Congressional refusal to endorse wholesale preemption of state law that affects securities. Report of the Senate Committee On Banking, Housing and Urban Affairs, S. Rep. No. 101-300, 101st Congress 2d Sess. at 64 (May 22, 1990) (App. p. 66a).[3] After describing

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[3] The Senate Committee noted the following with respect to concerns about the scope of federal preemption:

> During the Committee's consideration of S. 648, concerns were raised about the appropriateness of providing a regulatory agency with the authority to override state law through rulemaking. Due to the critical importance of strengthening the clearance and settlement system, the

(continued...)

the proposed legislation, the senate committee said that the proposed changes are *"intended to preserve State law as the principal source of rules for commercial transactions"*. 136 Cong. Rec., S13771-02, S13777 (Sept. 25, 1990) (App. 72a) (emphasis supplied). Congress' general reluctance to preempt the UCC is thus fully consistent with the historic interplay between the UCC and the federal securities laws.

There is, therefore, no general federal policy that would provide background support for the court below's holding that implied preemption can be found even when (i) federal law is silent, (ii) the SEC has stated that the matter is not subject to securities law rule, and (iii) a nationally uniform UCC provision does not conflict with any actual federal statutes or regulations.

B. THE IMPLIED PREEMPTION RULING

Despite all of the foregoing, the court below found implied preemption. The court advanced three general reasons. **First.** The court began by noting the "extensive" federal regulation "of margin transactions and broker utilization of customer funds" which includes some "commingling". It then added that, "[s]hort sales, too, are

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[3](...continued)

Committee determined that it was appropriate to provide the SEC with limited authority in this area. The Committee believes that the authority granted to the SEC to preempt state law in S. 648 *is carefully circumscribed so as to minimize the intrusive nature of the SEC actions.*

App. p. 67a (emphasis added).

the subject of complex and quite technical federal regulation" (App. p. 15a). How these observations support a conclusion of implied preemption is not readily apparent. Seemingly, they point in precisely the opposite direction. The lack of explicit regulation of interest payments shows that *no* federal intent to control payment of interest exists, as the SEC has repeatedly made clear.

Second. Unable to establish a direct conflict between § 9-207(2)(c) and any federal securities policy, the court advances a number of other arguments. Initially, we are told that petitioners' argument "would, if accepted, allow states to regulate the terms on which margin may be accepted by brokers as security, not only for short sales, but for all transactions on margin", especially with respect to rules governing commingling (App p. 16a-17a). This is wrong. To begin with, UCC § 9-207(2)(d) expressly permits commingling.. Thus, the "conflict" identified by the court is not with UCC § 9-207, but with some hypothetical state law that was not before the court. Far more important, however, were an actual conflict to exist, any federal policy expressed in the SEC rules -- such as the rules permitting commingling -- would have preemptive effect. Petitioners, it must be emphasized, make no challenge to SEC regulatory authority. *SEC v. Lehman Brothers Inc., supra* 157 F.3d at 8.

The court next makes a more diffuse claim. Petitioners, it said,

> would [] impermissibly intrude on federal regulation of broker-dealers and of margin and short sales [because] [r]egulation by the states

> would directly affect the very value of security posted pursuant to federal margin requirements. A secured lender who may retain earnings on collateral has more valuable security than a lender who must remit to the customer interest on the collateral. If states may regulate as [petitioner] contends, the effect of federal margin requirements on particular brokers and customers would depend in part on the vagaries of state law.

(App. p.17a). This, too, is incorrect. This litigation does not concern as-yet-unborn- state laws, but state law that is uniform throughout the land and which frequently applies to federally regulated securities. See *Lehman Brothers*, *supra*. Moreover, the fact is that brokers do not take the value of these profits into account when determining how much collateral a customer must deliver in order to satisfy applicable margin requirements.

The court below also states that sustaining 9-207(2)(c)'s applicability would mean that the broker-dealers' bookkeeping would have to be modified to allow for segregated accounts and interest earned, thereby "undermin[ing] congressional objectives in creating an effective, uniform system of short sale and margin regulation. See 15 USC § 78(b)" (App. p.18a). This argument is clearly wrong. It ignores, *inter alia*, that (i) commingling is permissible under both UCC § 9-207 and federal law and is not under attack; (ii) broker-dealers already account for interest on collateral in many other circumstances, and (iii) again, uniform customer agreements

on this topic are highly unlikely to prevent division of an effective, federal system.[4]

Third. In the end, the decision below seems to rest upon no more than the court's observation that "the industry practices challenged here have existed for at least most of this century and pre-date federal statutes and regulations described above" (App. p. 18a-19a). This is an easement theory of industry wrongdoing, and it must be rejected by this Court. Illegal industry practices remain illegal, regardless of how long-lived. "Even a universal industry practice may still be fraudulent." *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998); *see also, Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970).

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[4] The court's belief that to require brokers to calculate economic advantage attributed to the profits at issue would impose undue burden and hardship upon them (*see* App. at 18a n.12) similarly lacks merit. First, brokerage firms can simply agree with the customers respecting the profits on this collateral. Second, brokerage firms currently calculate and pay a portion of the collateral proceeds to certain customers (including petitioner Bissell) (*see* App. pp. 29a, 48a). The FRB and the SEC authorities cited by the court do not more than authorize a broker to take and use collateral in margin transactions. Significantly, these broker uses of collateral are expressly authorized by rule or by agreement, and that is why such practices are not under review here. This action does not challenge a broker's entitlement to collateral or to compensation for bearing the risk of extending credit on a stock loan. Challenged is their concealed profiting from the collateral. This practice is not authorized by either statute, rule, or contract.

The SEC itself, in a no-action letter, has made clear that payment of interest is a matter of negotiation:

> Inasmuch as no NYSE or commission rule prohibits or explicitly mandates the payment of interest on customer credit balances and monies generated from the lending of customer securities, the payment of such interest is a matter for negotiation between the customer and the broker dealer.

Norman P. Singer, SEC No-Action Letter, 1979 WL 14184 at *1 (July 12, 1979) (App. p. 74a).[5] Remarkably, however, the court below cites the SEC for the contrary notion, *viz*, that interest is not a matter for negotiation, *but is to be governed by a silent federal securities law, that inferentially* disregards New York substantive law and affirms that broker-dealers should both retain interest on customers' collateral and not inform the customers of their practice in so doing. This idea is contrary to the entire regulatory scheme established by the securities laws which foster consent and disclosure, to say nothing of the established principles of "Our Federalism."

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[5] The Federal Reserve Board also has made clear that it "does not regulate the payment of interest by either a broker-dealer or its customer" (App. 76a).

CONCLUSION

The petition for a writ of certiorari should be granted.

New York, New York
December 22, 1998

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT IN *RAIZY LEVITIN v. PAINEWEBBER, INC.* DATED AND DECIDED SEPTEMBER 29, 1998

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 1996

(Argued: April 14, 1997 Decided: SEP 29 1998)

Docket No. 96-7994

RAIZY LEVITIN,

Plaintiff-Appellant,

v.

PAINEWEBBER, INC.,

Defendant-Appellee.

Before: WINTER, *Chief Judge*, FEINBERG, and PARKER, *Circuit Judges*.

Appeal from an order of the United States District Court for the Southern District of New York (Denny Chin, *Judge*) dismissing Raizy Levitin's claims under Section 10(b) of the Securities and Exchange Act of 1934. Levitin argues that PaineWebber, Inc. committed securities fraud when it failed to disclose profits earned from collateral Levitin posted to secure short sale transactions. We affirm.

* * *

Appendix A

WINTER, *Chief Judge*:

Raizy Levitin brought this action on behalf of herself and a class of all others who engaged in short sales through accounts with PaineWebber, Inc. ("PW") after August 1992. Levitin claims that PW violated Section 10(b) of the Securities and Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(B), and New York law when PW realized profits from collateral securing her short sale transactions and failed to inform her of those profits or to remit them to her. Judge Chin dismissed her federal claims and declined to exercise supplemental jurisdiction over her state law claims. *See Levitin v. PaineWebber, Inc.*, 933 F. Supp. 325 (S.D.N.Y. 1996).

We hold that the failure to disclose profits on the posted collateral does not violate federal law because: (i) a reasonable investor would know that collateral securing short sale transactions could produce income; (ii) PW's failure to disclose profits from the use of such collateral did not constitute concealment of its misuse under state law of Levitin's property; and (iii) Levitin has not alleged any injury from PW's failure to disclose that it might negotiate with large investors remittance of some of the profits from their collateral. We therefore affirm the dismissal of Levitin's federal claims.

A. *"Short Sales"*

In 1994, Levitin signed a margin agreement and set up a trading account with PW, a registered broker-dealer. Thereafter, she engaged in a series of "short sales." "Short sale" is a term of art for well-established securities trading practices.[1] Briefly

1. This discussion is based primarily on Levitin's complaint and her standard contract with PW.

stated, a short sale involves a customer who, like Levitin, speculates that a particular stock will go down in price and seeks to profit from that drop, The transaction begins with the customer selling stock that she does not own. The customer "borrows" the stock to be sold, typically from her broker. The broker obtains the stock that it loans to the customer either from its own reserves or by borrowing it from external sources, such as other brokers or other customers. Later — sometimes considerably later — the customer "covers" the short by buying identical stock and restoring it to the broker-lender. If the price of the stock declines, as the customer hopes, the customer can purchase the stock at a lower price than the one at which she sold the borrowed stock, profiting from the difference between the sale and purchase prices.

Short sales are extremely risky. If the price of the stock increases, the customer must cover by using funds in excess of the proceeds from the sale. Because the price of a stock may increase very substantially, the potential losses associated with uncovered short sales are also very substantial.[2] Consequently, a broker who lends a customer stock for a short sale does not typically pay the proceeds of the sale to the customer to be spent when and how she wants, waiting for the customer to cover when and if it suits her. If a broker did that, the price might increase and the customer become insolvent or disappear, leaving the broker out the entire value of the stock — the price at the time of short sale plus its increase. Brokers therefore demand collateral, usually by taking an amount from the customer's account equal to the security required. The proceeds

2. In addition to bearing the risk of an adverse stock price shift, an uncovered short seller must pay to the party whose shares she borrowed any dividends that are distributed on the borrowed stock during the period that the short position is open.

from the sale will, of course, usually be available as security, but if those proceeds and the balance in the customer's account are not sufficient to satisfy the security requirement, the customer will have to post additional collateral.

The amount of security required is not entirely a matter for negotiation between broker and customer. The collateral posted must satisfy federal margin requirements associated with short trades. For short sales of nonexempted securities, Federal Reserve Board Regulation T requires that customers meet an initial margin requirement of 150 percent of the market value of the securities being sold. *See* 12 C.F.R. § 220.12(c)(1). The New York Stock Exchange imposes separate margin requirements for short sales. *See* NYSE Rule 431(c). Adjustments in the collateral posted must be made periodically as the price of the stock fluctuates. If the stock price increases, brokers may charge the customer interest until the appropriate amount of security is restored. Of course, a broker may require particular customers to post collateral in excess of that specified by Regulation T or the NYSE.

There is one further complication. Where the broker borrows the stock from external sources, the broker must secure the loan with collateral equal to at least 100 percent of the market value of the securities borrowed. *See* Reg. T, 12 C.F.R. § 220.12(c).

Again typically, a customer's account may involve a number of different kinds of investments and the posting of collateral for some or all of them. There may also be funds in a customer's account that are not posted as collateral or otherwise committed. The broker may, or may not, offer interest on such "free balances" through money market accounts. *See* Rule

15c3-2, 17 C.F.R. § 240.15c3-2 (addressing broker obligations with respect to customer free credit balances); Norman P. Singer, SEC No-Action Letter, 1979 WL 14184 at *1 (July 12, 1979) ("Inasmuch as no NYSE or Commission rule prohibits or explicitly mandates the payment of interest on customer credit balances and monies generated from the lending of customer securities, the payment of such interest is a matter for negotiation between the customer and the broker-dealer."). Customer accounts with brokers are generally not segregated, *e.g.* in trust accounts. Rather, they are part of the general cash reserves of the broker. *See* Rule 15c3-2 (requiring periodic statements containing notice that customer funds "are not segregated and may be used in the operation of the business"). When a customer posts collateral for the borrowing of stock in a short sale, the collateral — like the balance in the account — remains part of the broker's general cash reserves and is used by the broker in transactions that it hopes will generate profits. Brokers, therefore, typically earn a return on collateral that secures a short trade or other investment.

B. *Levitin's Complaint*

Paragraph 29 of Levitin's complaint sums up her allegations by stating that PW "borrows the customer's property, use (sic) it as it sees fit, benefits economically from such uses, and pays nothing for it." It further states that "[t]ypically, [PW] will not inform its customers of . . . the interest or profits . . . [PW earned] from using the customer's property." Finally, the complaint alleges that PW sometimes remits some of the money earned on collateral to "favored large customers" but does not disclose this fact to ordinary investors. Based on these allegations, Levitin asserts federal claims arising under Section 10(b) of the 1934 Act and state law claims of

breach of trust, breach of fiduciary duty, breach of implied covenants of good faith and fair dealing, and violation of Article 9 of the Uniform Commercial Code ("UCC").

PW moved to dismiss on various grounds, including a failure to allege that the omissions were material, made knowingly, and were in connection with a purchase or sale of securities — all these matters being elements of a Section 10(b) violation. The district court granted the motion on the ground that the alleged violations were not in connection with the purchase or sale of securities. The court declined to exercise supplemental jurisdiction over the state law claims.

The legal theories underlying Levitin's federal claims are not clear on the face of the complaint. At oral argument, Levitin's federal claims became more defined and can be described as follows: (i) she was deceived in that she did not know that PW might earn monies from her short sale transactions in addition to the usual broker's commission, *i.e.*, monies earned on the collateral she posted; (ii) she was deceived by PW's failure to disclose that it was misappropriating her state-law property rights in the collateral and in earnings on that collateral; and (iii) she was deceived by PW's failure to disclose that the remittance of earnings on the posted collateral was, for large favored customers, negotiable.[3] We discuss these claims in turn.

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3. At oral argument, Levitin's counsel stated that her federal claims depended upon a state-law right to any earnings on the collateral posted. If so, only (ii) is at issue. However, other statements by counsel seemed to assert theories not so dependent. We therefore address all three claims.

Appendix A

C. *Deception as to PW's Earnings from Collateral*

Levitin claims that PW's failure to disclose earnings on the collateral she posted violated Section 10b. To state a valid claim under that section, "plaintiffs must allege, among other things, 'material misstatements or omissions indicating an intent to deceive or defraud in connection with the purchase or sale of a security.' " *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 761 (2d Cir. 1991) (quoting *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 900 F.2d 576, 581 (2d Cir. 1990)). A fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

In our view, the issue in the instant matter is not the importance of the omitted fact. Rather, it is whether a reasonable investor would be misled by PW's omission of the fact that PW earns (or may earn) money from collateral posted in short-sale transactions. The fatal flaw in this theory is derived from the principle that certain information is "so basic that any investor could be expected to know it." *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (plaintiff assumed to have familiarity with nature of margin account); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988) ("The role of the materiality requirement is not to attribute to investors a childlike simplicity." (internal quotation marks omitted)); *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346, 351 (2d Cir. 1993) (A "reasonable investor must be deemed to have some understanding of diversification and some independent view as to how much risk she is willing to undertake."); *Newman v. L.F. Rothchild, Unterberg, Towbin*, 651 F. Supp. 160, 163 (S.D.N.Y. 1986)

("[T]hat a market decline can precipitate a margin call" is a fact "so basic that any investor could be expected to know it." (internal quotation marks omitted)).

In the present case, the allegedly omitted fact is that PW may profit from use of the collateral posted by Levitin in a short sale transaction. However, that fact is no more than that money has a time value, and the reasonable investor simply must be held to know this. An investor who is ignorant of the fact that free cash or securities may be used to earn interest or other kinds of financial returns is simply not reasonable by any measure. Indeed, the decision to engage in short trading — or to buy common stock for that matter — is generally a decision to forgo safer interest-bearing opportunities in order to seek out higher returns, albeit at greater risk. The reasonable investor knows, therefore, that a brokerage can earn profits from funds posted with it as security for short sale transactions. Aware of the time value of money, the reasonable investor in Levitin's position also knows that the longer a short sale remains open, the more value the investor gives up by losing the opportunity to use the collateral in another way and the more profit PW can make by using the collateral.

Indeed, Levitin's agreement with PW stated that free credit balances in her account would automatically be invested in one or more money-market accounts bearing interest selected by her.[4] It stated further that she would have to pay interest on any

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4. Although neither party in its brief addresses the substance of Levitin's contract, we may consider documents "integral to the complaint" on a motion to dismiss — "particularly where plaintiff has been put on notice" thereof. *Cortec Inds., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47 (2d Cir. 1991). Here, not only is Levitin's contract integral to her complaint and a document of which she has notice, but she has not objected to its inclusion in the record on appeal.

amount by which the price of the shorted stock increased. There is absolutely nothing in PW's agreement with Levitin suggesting that she might expect a profit from any event but a decline in the price of the shorted stock. Far from deceiving Levitin about the earning of money on her posted collateral, the agreement indicated uses of her money — money market accounts — that would earn interest, and events — increases in the price of the shorted stock — that might cause her to owe interest. It promised profit from the short sale only if the stock price declined.[5]

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5. Indeed, appellant's contract with PW can be read as stating that interest will not be paid on the proceeds of short sales. First, under the agreement, credit balances are invested in money market funds that bear interest. *See* Resource Management Agreement ("RMA") Paragraph 2. Second, credit balances are reduced when an account-holder purchases securities or otherwise withdraws funds. Purchases of securities or withdrawals in excess of existing credit balances generate loan (debit) balances, upon which interest is charged. *See* RMA Agreement Paragraph 12.

RMA Disclosure Documents available to Levitin provide that debits and credits occurring during the course of a day are summed, and the net debit or credit balance then is summed with the previous day's ending balance to determine the new debit or credit balance for the purpose of calculating interest. *See* PW's Statement of Credit Practices (issued pursuant to Rule 10b-16 and included in the Disclosure Documents). However, the Statement of Credit Practices further provides that "[c]redit balances resulting from a short sale are disregarded because this credit balance is used to collateralize stock borrowed to make delivery against a short sale." This statement would seem to inform a reasonable account-holder that proceeds from short sales do not off-set liabilities to PW for the purpose of calculating interest charges. Because interest charges are paid where there is a net liability owed to PW, the effect of not reducing the liability by the amount of the short sale proceeds is that interest is not earned on such monies.

Nor is there anything in industry practice that might cause Levitin to expect a return of the time value of her collateral. The practice of broker-dealers commingling funds securing short sales[6] and retaining earnings from the use of such funds is long-standing. It is mentioned in texts that are over two-generations old, *see* Charles H. Meyer, *The Law of Stockbrokers and Stock Exchanges* § 29, at 186 (1931) ("[u]sually no interest is allowed by the broker to the customer on the credit arising [from the short sale]"); Douglas Campbell, *The Law of Stockbrokers* 23 (2d ed. 1922) (same), and has been the subject of SEC "no-action" letters.[7]

Indeed, the practice of a financial institution using money deposited with it to obtain earnings is neither unknown nor

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6. Levitin's contract with PW expressly permitted PW to hypothecate property, including monies and securities, in her account and to commingle her property with its own or that held for others, all without notice to Levitin. *See* RMA Agreement Paragraph 8.

7. *See* Senator Paul S. Sarbanes, SEC No-Action Letter, 1979 WL 14039 at *2 (January 22, 1979) ("[T]here is no Commission rule requiring the payment of [ ] interest [on credit balances resulting from short sales]."); Norman P. Singer, SEC No-Action Letter, 1979 WL 14184 at *1 (July 12, 1979) (same); Robert Wyman, SEC No-Action Letter, 1979 WL 14083 at *4 (June 13, 1979) ("[T]he federal securities laws do not require in every instance that a broker-dealer pass on to its customers all the various discounts and other advantages that are available to securities professionals."); *cf.*, David P. Glick, Jr., SEC No-Action Letter, 1985 WL 54250 at *1 (April 5, 1985) (noting that broker-dealers may charge interest on debit balances while not paying interest on credit balances); Anna Newman, SEC No-Action Letter, 1971 WL 6731 (May 6, 1971) ("In general, it may be said that the payment or the charging of interest by a broker-dealer are matters governed by contract between the parties.").

unexpected, much less nefarious. That is precisely how banks make money. Some bank accounts are not interest-bearing — *e.g.*, most checking accounts — even though the balances in such accounts are used by banks to earn money. Even interest-bearing bank accounts — and money market accounts with brokers for that matter — do not return to the investor the amount earned but rather pay a contractual rate. None of these routine practices is regarded as deceptive or even unusual. Indeed, Levitin might as reasonably complain of PW's failure to disclose that the interest it pays to investors on money market accounts is less than that earned by PW on the amount in the account.

Levitin, therefore, is presumed to know that money has a time value and that PW would put to income-producing use any funds of hers that secured short sales. She was promised no profit or return on those funds except for the amount of decline in value of the underlying shares. The "mix" of information afforded Levitin was thus complete.

D. *Deception as to Misappropriation of Property*

At oral argument, Levitin advanced a legal theory based on federal law that was not clearly set out in her brief. She argued that, under New York law, the customer is either the owner of any earnings generated from collateral or such collateral is held by PW as a fiduciary for the customer. In Levitin's view, if she owned the collateral posted for the short sale or it was held in trust for her, she would be legally entitled to profits earned on it under New York law. If that is the case, PW's non-disclosure of earnings from the collateral and retention of those earnings was arguably material under Section 10b in that it failed to inform Levitin of facts that would alert

her to a violation of her rights under New York law. This omission would allegedly support a federal Section 10b claim under the so-called loss of state law remedies doctrine. *See Goldberg v. Meridor*, 567 F.2d 209, 221 (2d Cir. 1977); *RCM Securities Fund, Inc. v. Stanton*, 928 F.2d 1318, 1327 n.2 (2d Cir. 1991); *cf.* Scott E. Jordan, *Loss of State Claims as a Basis for Rule 10b-5 and 14A-9 Actions: The Impact of Virginia Bankshares*, 49 Bus. Law. 295, 313-14 (1993).

Levitin bases her state law ownership claims on Article 9 of the UCC, N.Y. [U.C.C.] Law § 9-207. Section 9-207(2)(c) of the UCC provides that absent a contrary agreement, profits realized from collateral while in the secured party's possession belong to the debtor. Levitin claims that Section 9-207 governs the collateral she deposited in her PW margin account. PW argues that the extensive federal regulation of short sales and margin preempt any such application of Section 9-207.[8] In our view, the analysis of whether that UCC provision applies to Levitin's transactions and of whether it is preempted overlap.

Article 9 of the UCC contains its own "reverse preemption" clause. The Article explicitly does not apply

> (a) to a security interest subject to any statute of the United States to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property.

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8. PaineWebber's argument on this point is made by reference to Merrill Lynch's brief in *Bissell v. Merrill Lynch*, __ F.3d __, No. 96-9136 (2d Cir. 1998).

N.Y. [U.C.C.] Law § 9-104(a). We have found little authority as to the import of Section 9-104(a) in the present context. The pertinent language is broad — "such [federal] statute governs the rights of parties to . . . [secured] transactions" — and would appear easily to include the detailed federal regulations governing short sales and margin that are detailed below. It is clear, however, that Section 9-104(a) at a minimum precludes the applicability of Article 9 to transactions where its application would be preempted. Arguably, therefore, Section 9-104(a) calls for analysis more sweeping than traditional preemption analysis. Because Levitin's claim cannot survive traditional preemption analysis, we do not explore further the unfamiliar ground occupied by Section 9-104(a).

We first note, however, that application of preemption analysis in the present context does little harm to federalism. Quite apart from Section 9-104(a), the established practices of short sales and margin and the UCC have peacefully co-existed for years, without any perception that the UCC governed, much less outlawed, them. Levitin cites absolutely no precedent for her state-law legal challenge to industry practices regarding the posting and use of margin. The silence surrounding the relationship of the UCC to margin transactions — until this lawsuit — itself speaks volumes about the inappropriateness of applying UCC § 9-207 to those transactions.[9] We are not dealing, therefore, with a state statute that was consciously intended to regulate the transactions in question.

To the extent that the UCC did purport to apply, however, it would be preempted. Whether a state law is preempted is a

9. Of course, the UCC governs explicit pledgor/pledgee relationships even where the *res* pledged is a security in other respects governed by federal law. *See* UCC § 8-321 cmt. 3. No such relationship is present in the instant matter.

matter of congressional intent. If Congress intended to exercise its constitutional authority to supersede the laws of a state, the Supremacy Clause requires courts to follow federal law. *See* U.S. Const., Art. VI, cl. 2; *Barnett Bank v. Nelson*, 517 U.S. 25, 30 (1996); *California Fed. Sav. & Loan Ass'n v. Guerra*, 479 U.S. 272, 280-81 (1987) (reviewing preemption doctrine). If the federal laws in question do not contain explicit language regarding preemption, as in the instant case, "courts must consider whether the federal statute's structure and purpose, or nonspecific statutory language, nonetheless reveal a clear, but implicit, preemptive intent." *Barnett Bank*, 517 U.S. at 31 (internal quotation marks omitted). Preemptive intent can be inferred: (i) where the federal statute created a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it," *id.* (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)); (ii) where federal law is in "irreconcilable conflict" with state law, *id.* (quoting *Rice v. Norman Williams Co.*, 458 U.S. 654, 659 (1982)); (iii) where compliance with both statutes is a "physical impossibility," *id.* (quoting *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963)); or (iv) where the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

Federal regulation of margin transactions and broker utilization of customer funds is extensive. As a general matter, Regulation T sets forth Federal Reserve Board margin requirements, *see* 12 C.F.R. § 220 (credit by brokers and dealers), and Rule 10b-16 requires, *inter alia*, the disclosure of credit terms in margin accounts, *see* 17 C.F.R. § 240.10b-16. More significant, however, are Rules 15c2-1 and 15c3-2, each

of which expressly permits broker commingling of customer funds and securities in certain situations, *see* 17 C.F.R. § 240.15c2-1 (hypothecation of customers' securities permitted with consent); 17 C.F.R. § 240.15c3-2 (commingling of customers' free credit balances permitted with notice), and Rules 15c3-1 and 15c3-3, which address broker capital and reserve requirements, *see* 17 C.F.R. § 240.15c3-1 (net capital requirements for broker dealers); 17 C.F.R. § 240.15c3-3 (requiring special reserve accounts to be set up for customer protection). The reserve requirements set forth in Rule 15c3-3 exist precisely because, as Levitin was informed, *see* Note 5, *supra*, customer funds are not segregated, but instead are at risk from commingling and hypothecation. In addition, the formula by which brokers calculate their reserve requirement obligations expressly includes customer free credit balances and the market value of short securities. *See* Rule 15c3-3a, 17 C.F.R. § 240.15c3-3a.

Short sales, too, are the subject of complex and quite technical federal regulation.[10] Briefly stated, Section 10(a) of the 1934 Act authorizes the Commission to promulgate regulations governing short sales. Such regulations were promulgated in 1938. Today, Rule 10a-1, 17 C.F.R. § 240.10a-1, sets forth general standards governing the relationship of terms of short sales and previously quoted prices, and Rule 10a-2, 17 C.F.R. § 240.10a-2, regulates the covering of short sales and prohibits naked (uncovered) transactions. In

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10. In addition to the technical regulations noted, brokers are under a general duty to give customers an understandable explanation of the nature and risks of short sales. *See Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454 (9th Cir. 1986). Apart from the allegations concerning the failure to disclose earnings from the posted collateral, Levitin has notably alleged no violation of this general duty.

addition, the Commission has promulgated rules further regulating short sales in connection with public offerings, *see* Securities Act Rule 105, 17 C.F.R. § 242.105, and tender offers, *see* Rule 14e-4, 17 C.F.R. § 240.14e-4. Finally, Regulation T sets forth initial margin requirements for short sales. *See* 12 C.F.R. § 220.12(c) & (d).

Levitin's argument would, if accepted, allow states to regulate the terms on which margin may be accepted by brokers as security, not only for short sales, but for all transactions on margin. Although UCC § 9-207 allows parties to depart from its rule by contrary agreement,[11] Levitin's argument in no way depends on state law being permissive in that regard. In short, her argument, if accepted, would allow a state to require that collateral be treated as the customer's property and that some form of interest be paid on that property. In light of the pervasive federal scheme governing the manner in which brokers may utilize customer securities and free credit balances, such state regulation would be in "irreconcilable conflict" with the federal regulation of margin and short sales.

First, a state law requiring customer collateral to be segregated would be in direct conflict with Rules 15c2-1 and 15c3-2, each of which permit the commingling of customer assets subject to certain consent and notice requirements, and in implicit conflict with Rule 15c3-3, which requires brokers

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11. Arguably, Levitin's contract with PW, which permits PW to commingle her property with its own, *see* note 5, *supra*, and which provides for her earning interest in some circumstances and paying it in others while not providing for the payment of interest on collateral for short sales, *see* note 4, *supra*, constitutes just such an agreement to the contrary. Again, however, Levitin's argument is not limited to state regulation that can be varied by private contract.

to set up special reserve bank accounts for the exclusive benefit of customers and to maintain balances therein according to a formula, promulgated by the SEC, that specifically contemplates the commingling of customer monies and the lending of customer securities. *See* Rule 15c3-3a (setting forth formula).

Limiting Levitin's theory to short sale proceeds would not alter the analysis. As Levitin's complaint alleges, "[a] short sale is a margin transaction," and nothing in federal law suggests that the proceeds of a short sale are not subject to SEC rules on margin and commingling or are otherwise to be handled differently from other customer credit balances. In fact, there would be little sense in treating the collateral in an open short position as Levitin suggests because the customer's long securities may be hypothecated or commingled and the funds held as collateral for a short sale would in any event be subject to commingling when the short sale was covered. The protection for customers from excessive risk-taking by brokers is afforded not through segregation requirements, such as UCC § 9-207 contemplates, but through detailed federal regulations of the operation of such businesses.

Second, even if Levitin's interpretation of state law were not in direct conflict with federal rules, it would nevertheless impermissibly intrude on federal regulation of broker-dealers and of margin and short sales. Regulation by the states would directly affect the very value of security posted pursuant to federal margin requirements. A secured lender who may retain earnings on collateral has more valuable security than a lender who must remit to the customer interest on the collateral. If states may regulate as Levitin contends, the effect of federal margin requirements on particular brokers and customers would depend in part on vagaries of state law.

Her argument would also enable the states to transform customers with margin accounts from the status of general creditors to that of pledgors. Such a prohibition on the commingling of margin with brokers' cash reserves would have significant consequences. Segregated trust accounts for margin transactions, or similar devices, would have to be kept so that the appropriate amount of interest would be paid to each customer and so that creditors of the broker would not be able to reach the collateral. *See* UCC § 9-207(1). This would alter bookkeeping, the maintenance of accounts, and the methods by which brokers are compensated for transactions on margin.[12] This in turn would undermine congressional objectives in creating an effective, uniform federal system of short sale and margin regulation, *see* 15 U.S.C. § 78(b) (Congress intended securities regulations to "remove impediments to . . . a national market system for securities and a national system for the clearance and settlement of securities transactions"), and would undermine the SEC policy of relying on competition to determine the economics of broker-client relationships, *see, e.g.*, Robert Wyman, SEC No-Action Letter, 1979 WL 14083 at *4 (June 13, 1979) ("The federal securities laws frequently rely on fostering competition — rather than the imposition of more direct forms of regulation — as a means of insuring that broker-dealers offer their services at competitively reasonable prices to their customers.").

Third, the industry practices challenged here have existed for at least most of this century and pre-date the federal statutes

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12. *Cf.* Robert Wyman, SEC No-Action Letter, 1979 WL 14083 at *3 (June 13, 1979) ("[B]ecause of the complexity of financial options available to the broker-dealer, it would be difficult — and expensive — to calculate the extent of any economic advantage attributable to the selection of a particular financing alternative in a specific transaction").

and regulations described above. The fact that Congress, the SEC, and the Federal Reserve Board have imposed such detailed regulations on short sales and on the use of margin without requiring brokers to pay interest on collateral or otherwise segregate such funds easily supports the inference that federal law is intended to permit such practices. *See* note 6, *supra*; *cf.* 17 C.F.R. § 1.29 (expressly permitting merchants subject to CFTC regulation to retain interest on customer funds posted as collateral).

In view of the pervasive federal regulating scheme that explicitly permits brokers to commingle customer funds and implicitly permits them to retain earnings on collateral posted for short sales, the intrusion of Levitin's claim on the methods by which short sales and other margin transactions are undertaken, and the direct bearing of that claim on the very value of margin to brokers, we find that "Congress [has] left no room for the States to supplement" federal law. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

We need not address whether Levitin's alternative theory of ownership — that a fiduciary duty between herself and PW entitles her to the profits realized from collateral — is preempted by federal law because it finds no support in New York law. Under New York law, "[a] broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities." *Perl v. Smith Barney Inc.*, 646 N.Y.S.2d 678, 680 (1st Dep't 1996) (finding no fiduciary duty governing broker/client relationship where broker allegedly overcharged fees in connection with nondiscretionary brokerage account (internal quotation marks omitted)). A fiduciary relationship arises "when one [person] is under a duty to act for or to give advice for the benefit of another within the scope of the

relation." *Flickenger v. Harold C. Brown & Co., Inc.*, 947 F.2d 595, 599 (2d Cir. 1991) (quoting *Mandelblatt v. Devon Stores, Inc.*, 521 N.Y.S.2d 672, 676 (1987) (quoting Restatement (Second) of Torts § 874 cmt. a)); *see also Richardson Greenshields Securities, Inc. v. Mui-Hin Lau*, 693 F. Supp. 1445, 1456 (S.D.N.Y. 1988) ("A broker who has discretionary powers over an account owes his client fiduciary duties."). Levitin has not alleged facts establishing such a fiduciary relationship and does not claim that PW's execution of short sales were discretionary acts on her behalf. Levitin's breach of fiduciary duty allegations therefore lack merit.

E. *Deception Regarding PW's Willingness to Negotiate Remittance of Earnings on Collateral*

Finally, we address Levitin's claims regarding the failure of PW to disclose that some large, favored customers are able to negotiate the partial remittance of earnings on collateral posted to secure short sales. There is a fatal defect in this claim, too.

Levitin's complaint does not allege — and her brief does not purport to argue — that she is a large customer who might have negotiated a remittance. Indeed, the class she seeks to represent consists of all investors who engaged in short sales through PW. She has not, therefore, alleged an individual injury from the alleged non-disclosure, and even less an injury to the class of which she is a member, given that even the large, favored investors negotiate remittances individually.

We do not address the issues that would arise if a plaintiff were to allege that she was a sufficiently large investor who, more probably than not, could have negotiated a remittance of

one size or another had she known of the possibility. There is no such allegation here, and the individual issues of causation and measure of damages would make such an action an unlikely candidate for class certification.

F. *Conclusion*

We therefore affirm. To the extent that our holding disposes of state claims based on an alleged state-law property right in the collateral securing Levitin's short sales, they are dismissed along with her federal claims. We affirm the district court's decision not to exercise jurisdiction over any remaining state law claims.

APPENDIX B — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT IN *LOUIS BISSELL, JR. v. MERRILL LYNCH & COMPANY, INC., et al.*, DATED AND DECIDED SEPTEMBER 29, 1998

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 1996

(Argued: April 14, 1997 Decided: SEP 29 1998)

Docket No. 96-9137

LOUIS BISSELL, JR., on behalf of himself and others similarly situated,

Plaintiff-Appellant,

v.

MERRILL LYNCH & COMPANY, INC. and MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendants-Appellees.

Before: WINTER, *Chief Judge*, FEINBERG, and PARKER, *Circuit Judges*.

Appeal from an order of the United States District Court for the Southern District of New York (Allen G. Schwartz, *Judge*) dismissing Louis Bissell's claims under Section 10(b) of the Securities and Exchange Act of 1934. We affirm for the reasons stated in *Levitin v. Painewebber, Inc.*, __ F.3d __, No. 96-7994 (2d Cir. 1998).

Appendix B

* * *

WINTER, *Chief Judge*:

Louis Bissell, Jr. appeals from Judge Schwartz's order denying his motion for class certification and dismissing his complaint for failure to state a claim. *See Bissell v. Merrill Lynch & Co., Inc.*, 937 F. Supp. 237 (S.D.N.Y. 1996).

The facts here are identical to those in *Levitin v. Painewebber, Inc.*, __ F.3d __, No. 96-7994 (2d Cir. 1998) but for two matters. The first difference is that instead of posting as collateral cash or securities other than those being sold short, Bissell traded "against the box." In trading "against the box," the customer posts as collateral shares he owns that are identical to or convertible into those being sold short. The second difference from *Levitin* is that Bissell was a large trader who was able to negotiate a remittance of the earnings realized by appellees on the shares he posted as collateral. He alleges, however, that only a portion of those earnings were remitted.

Neither difference is material, and we affirm for the reasons stated in *Levitin*.

APPENDIX C — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK IN *LOUIS G. BISSELL, JR. v. MERRILL LYNCH & CO., INC., et al.* DATED AUGUST 14, 1996 AND FILED AUGUST 15, 1996

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

93 Civ. 8243 (AGS)

LOUIS G. BISSELL, JR., on behalf of himself and all others similarly situated,

Plaintiff,

-against-

MERRILL LYNCH & CO., INC., and MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,

Defendants.

OPINION AND ORDER

ALLEN G. SCHWARTZ, DISTRICT JUDGE:

This matter is before the Court upon the motion of defendants Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated (collectively, "MLPF&S") to dismiss all claims alleged in the Second Amended Class Action Complaint (the "Complaint") under Rules 12(b)(6) and 9(b) of the Federal Rules of Civil Procedure, and the motion of plaintiff Louis G. Bissell, Jr. ("Bissell" or "plaintiff") for class certification. For the reasons set forth below, MLPF&S's motion is granted, and Bissell's motion is denied as moot.

Appendix C

BACKGROUND[1]

In this putative class action brought under the federal securities laws and New York statutory and common law, plaintiff seeks damages relating to short sales in his stock brokerage account with defendant MLPF&S. Plaintiff does not allege that MLPF&S deprived him of any investment gains, nor does he seek to hold MLPF&S responsible for any investment losses. Rather, plaintiff asserts that he and the putative class are entitled to all of the "interest, other profits or economic benefits earned [by MLPF&S] on . . . [customers'] property pledged as collateral in connection with such short sales . . . ." Complaint ¶ 5.

Plaintiff asserts his claims not under any provisions of federal law specifically regulating short sales and the use of customer collateral[2], but under (1) general principles of section

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1. The facts alleged in the Complaint are taken as true for the purposes of this motion to dismiss. Facts recited below are derived from the Complaint and from documents to which the Complaint specifically refers, namely, plaintiff's monthly account statements and margin agreement with MLPF&S. Reference to such documents is permitted on a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure. *See Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 48 (2d Cir. 1991), *cert. denied*, 503 U.S. 960, 112 S.Ct. 1561 (1992) (Court may consider documents neither incorporated by reference nor attached to the complaint where the plaintiff "had . . . [the documents] either in its possession or had knowledge of . . . [them] and upon which [documents] they relied in bringing suit.")

2. Although aspects of short sales are regulated by both the SEC and the Federal Reserve Board, no federal law or regulation specifically requires the payment of interest, other profits or economic benefits earned by brokers on customers' property pledged as collateral in connection with short sales. As the SEC staff has stated:

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10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78a *et seq.*, and Securities and Exchange Commission ("SEC") Rules 10b-5 and 10b-16, 17 C.F.R. §§ 240.10b-5 and 240.10b-16, (2) the common law of the State of New York, and (3) provisions of the Uniform Commercial Code.

Bissell opened a margin account with MLPF&S in 1981. Upon becoming a margin customer, Bissell signed MLPF&S's standard margin agreement. In January 1983 Bissell deposited 16,000 shares of common stock of E.I. DuPont de Nemours & Company ("DuPont") into his margin account at MLPF&S, and in 1985 he commenced the practice of selling DuPont short.

Some background on the mechanics and regulation of short sales is necessary to put plaintiff's claims in perspective. In a short sale transaction the customer borrows stock to sell, is credited with the proceeds, and then restores the borrowed stock by purchase, hopefully at a lower price. Thus, a short sale is the sale of a security that the seller does not own, or, if he or she owns it, does not deliver to the buyer. Where the seller owns the security but does not deliver it to the buyer, the transaction is referred to as a "short sale against the box."[3] The

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> Inasmuch as no NYSE or Commission rule prohibits or explicitly mandates the payment of interest on customer credit balances and monies generated from the lending of customer securities, the payment of such interest is a matter for negotiation between the customer and the broker-dealer.

Singer (Interest to the Client of Short Sales), SEC No-Action Letter, 1979 SEC No-Act LEXIS 3284, at *1 (August 12, 1979).

3. The rationale for short sales against the box is usually to speculate on the short-term decline of the "shorted" stock while

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monthly statements in Bissell's account reflect that all of Bissell's short sales were short sales against the box.

To secure the loan of stock, a short-selling customer is required to provide his or her broker with collateral in the form of cash or securities. In a "regular" short sale (as opposed to a short sale against the box), the collateral for the security loan usually takes the form of the cash proceeds received from the short sale, but securities may be substituted as collateral.[4] Whether in the form of cash or securities, however, SEC rules permit the broker-dealer to use the collateral to finance margin loans or security loans for the same or other margin customers. *See, e.g.*, 17 C.F.R. § 240.15c3-3.

In short sales against the box, the seller's collateral for the security loan always takes the form of securities, namely, the seller's own long security position "in the box." The cash proceeds from the short sale do not serve as collateral for the

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continuing to hold the long position for long-term appreciation, or to defer capital gains taxes (as permitted by the Internal Revenue Code).

4. Regulation T of the Federal Reserve Board requires that all short sales be made in a margin account because a short sale, whether a regular short sale or a short sale against the box, involves the collateralized loan of securities on which the broker may charge interest. *See* Regulation T, 12 C.F.R. § 220.4(a). For regular short sales of nonexempt securities, Regulation T requires that customers meet an initial margin requirement of 150 percent of the market value of the security being sold. *See* 12 C.F.R. § 220.18(c). The New York Stock Exchange ("NYSE") imposes separate maintenance margin requirements for short sales. *See* NYSE Rule 431(c); *see also* Regulation T, 12 C.F.R. § 220.1(b)(2) (permitting exchanges to impose margin requirements above those set by the Federal Reserve Board).

security loan in a short sale against the box.[5] To protect the integrity of the short sale against the box (*i.e.*, to assure that the long position is not delivered to the buyer), the broker-dealer segregates the seller's long position, thereby removing it from the pool of margin securities otherwise available to it for lending, pledging, hypothecation or any other purpose.

The broker obtains the stock that it loans to the customer from its own reserves or by borrowing it from other brokers or other customers, as permitted by standard margin agreements and applicable regulations. *See* 15 U.S.C. § 78h(c); 17 C.F.R. § 240.15c3-3(a)(3) and (4). When the broker borrows the stock from external sources, the broker must secure the loan with collateral worth at least 100 percent of the market value of the securities borrowed. Regulation T, 12 C.F.R. § 220.16. The funds used to secure the loan of stock may be taken directly or indirectly from the account of the customer engaging in the short sale, and typically are generated by the short sale itself.

Where the broker has provided collateral to another broker or institution to secure the loan of securities, the borrowing broker typically receives a portion of any interest earned on the collateral. The borrowing broker does not usually pass any

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5. While there is no initial margin requirement under Regulation T for short sales against the box, the NYSE does impose a maintenance margin requirement on short sales against the box of no less than 5 percent. *See* NYSE Rule 431(e)(1). NYSE member firms are free to impose higher (but not lower) margin requirements on their own. NYSE Rule 431(d). Thus, in a short sale against the box, the seller is free to withdraw up to 95 percent of the cash proceeds under NYSE Rule 431, but doing so incurs margin debt. *See* Plaintiff's Memorandum Opposing Defendants' Motion to Dismiss ("Opp. Mem.") at 4. In addition, the remaining five percent of the cash proceeds is available for the broker's use. *Id.*

of the interest on to its customer, although an exception is sometimes made for large or professional customers. Here, the Complaint and monthly account statements make clear that MLPF&S did, in fact, pass on some of this interest to Bissell. In September 1985, MLPF&S agreed to credit Bissell's account with 50 percent of Broker Call Rate ("BCR") interest on the entire short market value ("SMV") of his open short positions. This arrangement is reflected in Bissell's monthly statement for September 1985 and each month thereafter, and was made retroactive to January 1, 1985. In 1989, for example, Bissell's account was credited with $44,255.58 in interest, in effect reducing his 1989 margin interest charges from $94,429.97 to $50,174.39. *See* Complaint ¶ 32.

In essence, the Complaint in this action alleges that MLPF&S uses its customers' assets, in the form of cash and stock collateral and proceeds of short sales, to earn interest and to obtain other financial benefits without notifying the customer of this practice or sharing the proceeds with them. Based upon these allegations, Bissell and the putative class assert claims for securities fraud, breach of fiduciary duty, violation of the "shingle theory" and principles of trust and agency, breach of implied covenants of good faith and fair dealing, and violation of Article 9 of the Uniform Commercial Code.[6]

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6. Plaintiff asserts his state law claims under the Court's diversity jurisdiction as well as its supplemental jurisdiction. In a recent letter to the Court, MLPF&S suggests for the first time that the Court reject plaintiff's invocation of diversity jurisdiction and decline to exercise supplemental jurisdiction under 28 U.S.C. § 1367. MLPF&S argues that while the Complaint alleges the parties' diverse domiciles, plaintiff fails to allege the amount in controversy as required under 28 U.S.C.

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Appendix C

Although captioned "Second Amended Class Action Complaint," the pending Complaint is actually plaintiff's fourth complaint in this action. It was preceded by a "Substituted Amended Class Action Complaint," an "Amended Class Action Complaint," and an original "Class Action Complaint." Plaintiff has agreed and this Court has "so ordered" that the pending Complaint is "the final complaint in this action and said complaint may not be amended hereafter for any reason." *See* Stipulation and Order dated October 11, 1994.

DISCUSSION

A. *Standard for Motion to Dismiss*

In ruling upon MLPF&S's motion to dismiss the Complaint under Rule 12(b)(6), the Court must view the Complaint in the light most favorable to Bissell, accepting all allegations contained in the Complaint as true. *See Scheuer v. Rhodes*, 416 U.S. 232, 236, 94 S.Ct. 1683, 1686 (1974). All reasonable inferences are to be drawn in the plaintiff's favor, and the claims should not be dismissed unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim[s] which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 101-102 (1957).

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§ 1332(a). The Court, however, declines to rule on this basis. The Complaint indicates that the amount in controversy exceeds $50,000. *See* Complaint ¶ 32 ("Thus, in this single example, MLPF&S misappropriated most, if not all, of $50,174.39 of revenues"). Accordingly, the Court reaches the merits of the arguments regarding dismissal of the state law claims.

Appendix C

B. *Securities Fraud Claims*

Bissell bases his securities fraud claims upon MLPF&S's alleged violation of two SEC rules promulgated under section 10(b) of the 1934 Act: Rule 10b-5 and Rule 10b-16.

1. *Rule 10b-5*

To state a claim under section 10(b) and Rule 10b-5, a plaintiff must allege that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 264 (2d Cir. 1993) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61 (2d Cir. 1985)), *cert. denied*, __ U.S. __, 114 S.Ct. 1397 (1994) (internal quotations omitted). The Supreme Court recently stated that Rule 10b-5 should be interpreted strictly to bar "10b-5 challenges to conduct not prohibited by the text of the statute." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, __, 114 S.Ct. 1439, 1446 (1994). The Court emphasized that " 'not every instance of financial unfairness constitutes fraudulent activity under § 10(b).' " *Id.* (citation omitted).

Here, plaintiff's claim under Rule 10b-5 must be dismissed because it fails to satisfy the requirement that the alleged fraud was "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. To satisfy this requirement, the misrepresentation or omission must pertain to the securities themselves; allegations of fraud merely involving securities are not sufficient. *See Chemical Bank v.*

Arthur Anderson & Co., 726 F.2d 930, 943 (2d Cir.), *cert. denied*, 469 U.S. 884, 105 S.Ct. 253 (1984). Judge Chin of this Court recently dismissed a securities fraud complaint similar to Bissell's, holding that the broker-dealer's alleged "failure to disclose that it earned interest on its customers' collateral and the proceeds of their short sales was not 'in connection with' the purchase or sale of securities." *Levitin v. PaineWebber, Inc.*, No. 95 Civ. 6508, 1996 WL 384912 (S.D.N.Y. July 10, 1996), at *4. I concur with Judge Chin's thorough analysis of the "in connection with" requirement in *Levitin* and reach the same conclusion here.

The law of this Circuit is clear that unless the alleged fraud concerns the value of the securities bought or sold, or the consideration received in return, such fraud is not "in connection with" the purchase or sale of a security within the meaning of Rule 10b-5. *See Chemical Bank*, 726 F.2d at 943 (claim against accountants for losses related to loans secured by notes of company audited by the accountants held not to be "in connection with" the purchase or sale of a security); *Saxe v. E.F. Hutton & Co., Inc.*, 789 F.2d 105, 108 (2d Cir. 1986) (claim that investor was fraudulently induced to liquidate securities portfolio to invest proceeds with commodities trader held not to be "in connection with" the sale of a security").

In *Chemical Bank*, a leading decision on the "in connection with" requirement of Rule 10b-5 liability, Judge Friendly described the rationale for this requirement as follows:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions — to make sure that buyers of securities get what they think they are getting and that sellers of

> securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.
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> [I]t is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the [purchase or sale] of a security is a part.

726 F.2d at 943. Although some commentators and courts have suggested that the connection between fraud and a securities transaction can be very tenuous and still satisfy the "in connection with" requirement, Judge Friendly rejected this view in *Chemical Bank*. He noted that statements to this effect "have usually been made in cases . . . where the connection was anything but tenuous. In cases near the borderline, courts have warned that '[i]t is important that the standard be fleshed out by a cautious case-by-case approach.' " *Id.* at 942 (citations omitted).

Following *Chemical Bank*, courts in this Circuit have consistently held that "there is no securities law violation unless the misrepresentations or omissions involved in a securities transaction pertain to the securities themselves." *Abrash v. Fox*, 805 F.Supp. 206, 208 (S.D.N.Y. 1992) (clients' claims against attorney for securities fraud held not to be in connection with the purchase of securities where claim alleged that attorney made misrepresentations as to his qualifications and intentions to act as business and legal advisor); *see also Pross v. Katz*, 784 F.2d 455, 457-58 (2d Cir. 1986) (investment manager's alleged breach of promise to perform fiduciary duties held not

to be in connection with purchase or sale of securities); *Manufacturers Hanover Trust Co. v. Smith Barney, Harris Upham & Co.*, 770 F.Supp. 176, 181 (S.D.N.Y. 1991) (alleged embezzlement of securities by broker did not constitute violation of Rule 10b-5; "in connection with" requirement was not satisfied because "Rule 10b-5 is designed to protect market transactions, not trust relationships"); *Bosio v. Norbay Sec., Inc.*, 599 F.Supp. 1563, 1566 (E.D.N.Y. 1985) (conversion by broker of proceeds of sale of a security not "in connection with" sale of the security because the broker's misrepresentation related "not to any inducement . . . regarding the investment purpose of the sale, but to the arrangements concerning the mechanics of the sale").

Bissell argues that "a fraudulent act need not affect the value of securities" to violate section 10(b) and Rule 10b-5. Opp. Mem. at 18. However, neither of the cases relied on by plaintiff — *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615 (9th Cir. 1981), and *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967) — go "so far as [plaintiff] would take us here." *Chemical Bank*, 726 F.2d at 944. Judge Friendly discussed the reach of both *Arrington* and *Brod* in *Chemical Bank*. He noted that *Arrington* was "a classic case of misrepresentation by a broker with respect both to the specific securities being purchased and to the lack of risk in margin buying." *Id.* at 944 n.24. In *Brod*, "there was no question that the [defendants'] fraud (placing orders for securities with the fraudulent intent of paying only if those had appreciated by the time payment was due) was in connection with the purchase and sale of securities." *Id.* Thus, neither *Arrington* nor *Brod* supports plaintiff's expansive view of the "in connection with" requirement.

Appendix C

The facts and holding of *Vigilant Ins. Co. v. C. & F. Brokerage Servs.*, 751 F.Supp. 436 (S.D.N.Y. 1990), are particularly instructive here. In *Vigilant*, an exchange specialist firm employed "finders" or middle-men to locate stock from other brokerage houses in order to fund commitments to its own clients and cover its position in the market. The specialist firm provided cash collateral to the finders for the loans. Once the specialist firm covered its position in the market, it returned the stocks and received back the collateral. In addition to receipt of its collateral, the specialist firm was to receive an interest payment or "rebate." The finders allegedly diverted those rebates to themselves. The specialist's fidelity insurer sued the finders for securities fraud under section 10(b), seeking to recover the misappropriated rebates. In dismissing the securities fraud claim, the court held that "to adequately state a cause of action [under section 10(b) and Rule 10b-5], the misrepresentation must relate to the value of the security." 751 F.Supp. at 438. The court further noted that "the fraud alleged regards retention of interest on the collateral [for stock loans] and a diversion of proceeds, neither of which affects the worth of the stocks." *Id.* Therefore, since the investment value of the stocks involved was not related to the finder's alleged fraud, the court held that the "in connection with" requirement was not satisfied. *Id.*

Here, as in *Vigilant*, the alleged fraud relates to the retention of interest on collateral rather than the value of the securities sold by Bissell or the price that he received for selling those securities. As the Second Circuit's decisions in *Chemical Bank* and *Saxe* make clear, a fraud is "in connection with" the purchase and sale of securities when the fraud concerns the value of the securities bought or sold, or the consideration received in return. As noted above, Judge Friendly held in

Chemical Bank that "it is not sufficient to allege that a defendant has committed [fraud] in a transaction of which the [purchase or sale] of a security is a part." 726 F.2d at 943. Bissell makes no allegation that MLPF&S's allegedly fraudulent practices related in any way to the value of the securities that plaintiff sold short or the consideration he received. Although the "nondisclosure of the interest [MLPF&S] earned on its customer's funds may have affected the customer's decision to open an account with defendant, the interest is not part of the consideration received by the customer for the sale of securities." *Levitin*, 1996 WL 384912, at * 3 (citing *Saxe*, 789 F.2d at 108). As Judge Chin held in *Levitin*, the "alleged nondisclosure at issue . . . pertains not to the sale of the securities or the value of the securities themselves, but to the terms of the relationship between the broker and the customer." *Id.* Accordingly, the alleged nondisclosure does not constitute securities fraud in violation of section 10(b) and Rule 10b-5.

Since MLPF&S's alleged failure to disclose that it earned interest on its customers' collateral and the proceeds of their short sales was not "in connection with" the purchase or sale of securities, plaintiff's securities fraud claim based upon Rule 10b-5 is hereby dismissed. Because I hold that Bissell has failed to satisfy the "in connection with" requirement, I need not reach MLPF&S's arguments that plaintiff has failed to adequately plead other elements of his securities fraud claim.

2. *Rule 10b-16*

Plaintiff also alleges that MLPF&S violated SEC Rule 10b-16, the SEC analogue to the Truth-in-Lending Act. *See* 17 C.F.R. § 240.10b-16. Rule 10b-16 prohibits brokers from extending credit to customers in securities transactions without

disclosing the terms of the extension of credit, including interest rates, the method of determining balances, and other charges resulting from the extension of credit. *See Levitin*, 1996 WL 384912, at *5. Plaintiff alleges that MLPF&S's conduct violated Rule 10b-16's requirements concerning disclosure of (a) finance charges, (b) conditions under which annual rates of interest can be charged, (c) rebates, (d) methods of computing interest, (e) methods of determining debit balance or balances on which interest is to be charged and whether credit is to be given for credit balances in cash accounts, (f) other charges resulting from extensions of credit, and (g) the nature of the broker's interest in the security or other property held as collateral and the conditions under which additional collateral can be required. Complaint ¶ 40.

Although Rule 10b-16 does not create an express cause of action for violation of its provisions and the Second Circuit has declined to resolve the issue of whether an implied cause of action exists, *see Zerman v. Ball*, 735 F.2d 15 (2d Cir. 1984), other circuit and district courts have recognized an implied cause of action under section 10(b) of the 1934 Act for violations of Rule 10b-16. *See, e.g., Angelastro v. Prudential-Bache Secs., Inc.*, 764 F.2d 939, 949-50 (3d Cir.), *cert. denied*, 474 U.S. 935, 106 S.Ct. 267 (1985); *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 539 (9th Cir. 1984); *Liang v. Dean Witter & Co.*, 540 F.2d 1107, 1113 n.25 (D.C. Cir. 1976); *Metzner v. D.H. Blair & Co.*, 689 F.Supp. 262 (S.D.N.Y. 1988); *Slomiak v. Bear Stearns & Co.*, 597 F.Supp. 676 (S.D.N.Y. 1984).

As with the other SEC regulations promulgated under section 10(b) of the 1934 Act, however, "a cause of action for violation of Rule 10b-16 can only be maintained where the

claim stems from the enabling statute's prohibition of the use of deceptive and manipulative devices in connection with the purchase or sale of securities." *Levitin*, 1996 WL 384912, at *4; *see Angelastro*, 764 F.2d at 946; *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1358 n.8 (11th Cir. 1985) (without deciding issue, court stated that "violations of Rule 10b-16 may give rise to a private cause of action under section 10(b) only to the extent that the violations arise out of the purchase or sale of securities"); *cf. Metzner*, 689 F.Supp. at 267 (holding that plaintiff stated claim for violation of Rule 10b-16 where it could be inferred that plaintiffs were misled into purchasing securities due to broker's violation of Rule 10b-16). Here, as in *Levitin*, where the alleged fraud does not pertain to the purchase or sale of securities, Bissell cannot recover under section 10(b) for the alleged violations of Rule 10b-16. *Levitin*, 1996 WL 384912, at *6.

Even if this Court were to hold that the alleged non-disclosures *did* pertain to the purchase or sale of securities, three alternative grounds exist for dismissing plaintiff's claims under Rule 10b-16: (1) the statute of limitations for certain claims under Rule 10b-16 has expired; (2) plaintiff does not allege that MLPF&S failed to establish procedures to provide the requisite Rule 10b-16 disclosures; and (3) Rule 10b-16 does not require the specific disclosures which plaintiff contends that MLPF&S failed to make.

The Complaint does not specify which specific provision of Rule 10b-16 was allegedly violated. Subsection (a)(1) requires the broker to establish procedures to assure that each customer is given a written statement disclosing information regarding interest charges at the time an account is opened; subsection (a)(2) requires the broker to establish procedures to

assure that each customer is given periodic statements disclosing credit balances, interest charges, and all other charges resulting from the extension of credit.

Plaintiff appears to concede that any claim based on subsection (a)(1) is time-barred, *see* Opp. Mem. at 21 ("a claim under 10b-16(a)(1) may now be time barred"), and the Court so finds. Litigation under section 10(b) "must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston*, 501 U.S. 350, 363, 111 S.Ct. 2773, 2782 (1991). Bissell opened his margin account in 1981 but did not commence this action until December 1, 1993. Thus, any claim under subsection (a)(1) of Rule 10b-16 based on MLPF&S's alleged failure to disclose credit information when Bissell's account was opened is time-barred because it was filed more than three years after the alleged violation.

In addition, courts recognizing an implied right of action under Rule 10b-16 have required the plaintiff to allege that the defendant failed to establish procedures to provide the requisite Rule 10b-16 disclosures. *See Slomiak*, 597 F.Supp. at 685; *see also Nick v. Shearson/American Express, Inc.*, 612 F.Supp. 15, 18 (D. Minn. 1984) (plaintiff must allege that defendants "failed to establish procedures to provide credit disclosure or that the terms initially established for the . . . [plaintiff's] account . . . were changed without the required notice"). Bissell's Complaint fails to make such allegations.

Finally, plaintiff's discussion in his Opposition Memorandum regarding the adequacy of MLPF&S's monthly statements demonstrates that there is no violation of the specific

disclosure requirements of subsection (a)(2) of Rule 10b-16. In his memorandum, plaintiff reproduces certain entries from his monthly statement for September 1985. After commenting (with apparent approval) on MLPF&S's disclosures relating to interest charges, plaintiff finds fault with the entries relating to interest credits. Specifically, plaintiff states that

> with respect to credit interest ("Cr. Int."), Merrill Lynch simply reported "50% BCR SMV." ("BCR" means "brokers call rate"; "SMV" means "short market value".) *Merrill Lynch did not quantify BCR.*

Opp. Mem. at 9 (emphasis added). However, unlike disclosures relating to interest *charges* which do require an itemized breakdown under Rule 10b-16, there is no SEC rule or regulation requiring any particular disclosure format with respect to interest *credits*.

For the foregoing reasons, plaintiff's claim under Rule 10b-16 is hereby dismissed.

B. *Other Claims*

1. *Breach of Fiduciary Duty, the Shingle Theory, and Principles of Trust and Agency*

In his third claim for relief, plaintiff asserts that under the law of New York, MLPF&S, "as a broker acting as agent for its customers, is under a fiduciary duty to deal fairly and in complete candor with its customers concerning the matters entrusted to the broker, and not to misappropriate the economic benefits of collateral or property of the *cestui qui* trust." Complaint ¶ 44. In his fourth and fifth claims, plaintiff alleges

similarly that MLPF&S violated the "shingle theory"[7] and principles of "trust and agency" in connection with his short sales. Since these claims all allege theories of fiduciary law, they will be resolved together.

The issue posed by these related claims is whether MLPF&S owes plaintiff a fiduciary or agency duty with respect to the specific practices regarding collateral in dispute in this action. MLPF&S concedes that it owes a fiduciary duty to the plaintiff — arising from its role as plaintiff's agent — to execute his securities transactions at the best prices reasonably obtainable. Plaintiff makes no allegation that MLPF&S failed to carry out this obligation. However, MLPF&S disputes that it owes plaintiff a fiduciary duty with respect to the collateral practices in question, arguing that the duty which plaintiff seeks

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7. The "shingle theory" denotes the proposition that a broker-dealer, by holding itself out as competent to conduct a brokerage business, owes its customer certain duties, including the duty not to sell securities at prices far in excess of market prices. *See, e.g., Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943), *cert. denied*, 321 U.S. 786, 64 S.Ct. 781 (1944); *see also* 8 Louis Loss & Joel Seligman, Securities Regulation 3772-98 (3d ed. 1991). Recent cases have harmonized the older "shingle theory" cases with the Supreme Court's Rule 10b-5 fraud jurisprudence by identifying both a duty to disclose and a material omission. Loss & Seligman, *supra*, at 3778. To the extent plaintiff's "shingle theory" claim relies on a violation of section 10(b) and Rule 10b-5, the claim must fail because (1) a breach of fiduciary duty does not give rise to a securities fraud claim merely because it involves a securities transaction, *see Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 479-80, 97 S.Ct. 1292, 1304 (1977), and (2) the alleged nondisclosure was not in connection with the purchase or sale of securities, as discussed above. *See Levitin*, 1996 WL 384912, at *4. To the extent plaintiff merely seeks to rely on breach of a fiduciary duty, the "shingle theory" claim will be considered in tandem with plaintiff's state law fiduciary and agency claims.

to impose does not implicate MLPF&S's role as plaintiff's agent or fiduciary. Rather, MLPF&S contends, such a duty arises — if at all — from the relationship with MLPF&S recognized in plaintiff's margin agreement, namely, that of debtor and creditor. The Court agrees, for the reasons set forth below.

Under New York law, the " 'mere existence of a broker-customer relationship is not proof of its fiduciary character.' " *Rush v. Oppenheimer & Co.*, 681 F.Supp. 1045, 1055 (S.D.N.Y. 1988) (quoting *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974)). The fiduciary obligation between a broker and customer under New York law is limited to affairs entrusted to the broker, and "[t]he scope of affairs entrusted to a broker is generally limited to the completion of a transaction." *Schenck v. Bear, Stearns & Co.*, 484 F.Supp. 937, 947 (S.D.N.Y. 1979), *overruled on other grounds*, *Conway v. Icahn & Co.*, 16 F.3d 504 (2d Cir. 1994). In the absence of discretionary trading authority delegated by the customer to the broker — and none is alleged in the case at bar — a broker does not owe a general fiduciary duty to his client. *Schenck*, 484 F.Supp. at 946-47.

The law of states other than New York is similar. The Arizona Supreme Court has stated that

> [t]he agency relationship between customer and broker normally terminates with the execution of the order because the broker's duties, unlike those of an investment advisor or those of a manager of a discretionary account are only to fulfill the mechanical, ministerial requirements of the purchase or sale of the security . . . . While a broker and a customer have an agent-principal relationship with respect to each transaction to buy or sell, they

> may also have a separate and distinct relationship as creditor and debtor.

Walston & Co. v. Miller, 100 Ariz. 48, 51-52, 410 P.2d 658, 661 (1966); *see also Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561 (9th Cir. 1985) (finding no continuing fiduciary relationship where customer had a non-discretionary account with broker); *Leib v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 461 F.Supp. 951 (E.D. Mich. 1978) (finding that broker owed only limited, transactional duties to customer who maintained non-discretionary account), *aff'd*, 647 F.2d 165 (6th Cir. 1981). The SEC has also recognized that the relationship of brokers to customers with respect to credit and debit balances in their accounts is that of debtor and creditor. In adopting Rule 15c3-2 governing the use of free credit balances in customer accounts, the SEC explained:

> Many customers of broker-dealers are not aware (1) that when they leave free credit balances with a broker-dealer the funds generally are not segregated and held for the customer, but are commingled with other assets of the broker-dealer and used in the operation of the business, and (2) that the relationship between the broker-dealer and the customer as a result thereof *is that of creditor-debtor*.

Adoption of Rule 15c3-2 under the Securities Exchange Act of 1934, Exchange Act Release No. 34-7325, 1964 SEC LEXIS 131, *2-3 (1964) (emphasis added). *See also* Newman, SEC No-Action Letter, [1970-71] Fed. Sec. L. Rep. (CCH) ¶ 78,177 (May 6, 1971) (declining to require payment of interest on free

credit balances, SEC staff found the question "governed by contract between the parties").

Relying primarily on *Conway v. Icahn & Co.*, *supra*, plaintiff argues that the relationship between plaintiff and MLPF&S is fiduciary in nature in *every* respect. Although there is language in Conway broadly stating that "[t]he relationship between a stockbroker and its customer is that of principal and agent and is fiduciary in nature," 16 F.3d at 510, a close analysis of the *Conway* case reveals that it does not support plaintiff's position.

In *Conway*, the plaintiff was a customer of a discount brokerage, Icahn & Co., which cleared its transactions through another broker-dealer, Cowen & Co. *Conway*, 16 F.3d at 505. Cowen & Co., not a party to the lawsuit, extended credit to plaintiff in his margin account. Plaintiff alleged that his relationship with Icahn & Co. was such that he did not permit Icahn & Co. to buy or sell securities in his account without his prior permission. In contrast, plaintiff's margin agreement with clearing broker Cowen & Co. permitted it to liquidate securities in plaintiff's margin account without prior notice to plaintiff. In October 1987, after a precipitous decline in stock prices and a corresponding deterioration in plaintiff's equity in his margin account, Cowen & Co. directed Icahn & Co. to liquidate securities in plaintiff's account to meet Cowen & Co.'s minimum margin requirements. *Id.* at 505-07. Addressing these facts and the status of Icahn & Co. as introducing broker, the Second Circuit stated the fairly unremarkable position that Icahn & Co. owed a fiduciary duty as an agent of the plaintiff to inform him of Cowen & Co.'s margin call and to give him an opportunity to deposit additional collateral. *Id.* at 510. The Circuit made clear that Cowen & Co., as plaintiff's creditor, stood in a categorically different relationship with plaintiff.

Here, MLPF&S does not utilize a clearing broker. It is "self-clearing" and as such occupies two roles: that of plaintiff's broker, and that of plaintiff's creditor. As plaintiff's broker, MLPF&S is under a fiduciary duty to execute his transactions at the best prices reasonably available and to offer honest and complete information when recommending the purchase or sale of a security. As plaintiff's creditor, MLPF&S has no fiduciary obligations. This important distinction is lost in plaintiff's argument that MLPF&S had a fiduciary duty to disclose information regarding its retention of interest on collateral and short sale proceeds.

Because the obligations plaintiff seeks to impose on MLPF&S do not arise from affairs entrusted to the broker as a fiduciary, agent, or trustee of the plaintiff, there can be no claim for breach of fiduciary duty, the "shingle theory," or principles of trust and agency on the facts of this case. Accordingly, plaintiff's third, fourth, and fifth claims are hereby dismissed pursuant to Rule 12(b)(6).

2. *Breach of Implied Covenants*

In his sixth claim, plaintiff alleges that MLPF&S violated implied covenants of good faith and fair dealing contained in his pledge agreement with MLPF&S. Complaint ¶¶ 51-54. For the reasons set forth below, this claim is also dismissed pursuant to Rule 12(b)(6).

Under New York law, "[a] party's actions may implicate the implied covenant of good faith when it acts so directly to impair the value of the contract for another party that it may be assumed that they are inconsistent with the intent of the parties." *Bank of China v. Chan*, 937 F.2d 780, 789 (2d Cir. 1991).

"[N]either party to a contract shall do anything that has the effect of destroying or injuring the right of the other party to receive the fruits of the contract," or to violate the party's presumed or reasonable expectations. *M/A-COM Security Corp. v. Galesi*, 904 F.2d 134, 136 (2d Cir. 1990).

An impled covenant of good faith and fair dealing, however, "arises only out of the known reasonable expectations of the other party which arise out of the agreement entered into. The covenant does not create duties which are not fairly inferable from the express terms of that contract." *Interallianz Bank AG v. Nycal Corp.*, No. 93 Civ. 5024, 1994 WL 177745 (S.D.N.Y. 1994), at *8 (citing *Fasolino Foods Co. v. Banca Nazionale del Lavoro*, 961 F.2d 1052, 1056 (2d Cir. 1992)).

Here, Bissell attempts to use the implied covenants claim to create additional duties not fairly inferable from the express terms of his pledge agreement with MLPF&S. The customer agreement with MLPF&S that Bissell signed contained the following provision:

> **Pledge of Securities and Other Property**
>
> All securities and other property now or hereafter held, carried or maintained by you in your possession in any of the accounts of the undersigned may be pledged and repledged by you from time to time, without notice to the undersigned, either separately or in common with other such securities and other property, for any amount due in the accounts of the undersigned, or for any greater amount, and you may do so without retaining in your possession or under your control for delivery a like amount of similar securities or other property.

Appendix C

See Exhibit M to Memorandum in Support of Defendants' Motion to Dismiss Plaintiff's Second Amended Class Action Complaint ("Def. Mem.").

This pledge agreement does not require payment to plaintiff of any "interest, other profits or economic benefits" earned on customers' property pledged as collateral in connection with short sales, nor does it require disclosure of the fact that MLPF&S may generate revenues from customer collateral and short sale proceeds. Plaintiff's implied covenant theory, if adopted by this Court, would create a duty well beyond the duties inferable from the express terms of the pledge agreement itself. Accordingly, MLPF&S's motion to dismiss Bissell's sixth claim for relief is granted.

3. *UCC Claim*

In his seventh and final cause of action, plaintiff alleges a claim under New York's Uniform Commercial Code and underlying common law principles. Section 907 of the UCC provides in relevant part:

> (2) Unless otherwise agreed, when collateral is in the secured party's possession
>
> . . .
>
> (c) the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation . . . .

N.Y. [U.C.C.] Law § 9-207(2)(c) (McKinney 1990). Plaintiff alleges that MLPF&S's practices violate section 9-207(2)(c) of the Code "by neither remitting the profits from the collateral nor by applying such profits in reduction of the secured obligation." Complaint ¶ 58.

Assuming, *arguendo*, that section 9-207(2)(c) applies to the situation herein[8], Plaintiff's claim under section 9-207(2)(c) is clearly barred by the terms of the provision itself. Section 9-207(2)(c) requires the secured party to apply any money received from the collateral to the reduction of the outstanding debt "[u]nless otherwise agreed." *See* N.Y. [U.C.C.] Law § 9-207(2) (McKinney 1990). The parties here have "otherwise agreed" since at least 1985, when Bissell arranged with MLPF&S to receive interest based on the short market value of his open short sales. This arrangement is reflected in Bissell's monthly statements, starting with his statement for September 1985. *See* Exhibit E to Def. Mem. This agreement continued in effect through the filing of MLPF&S's motion to dismiss, and Bissell concedes that he received a total of $44,255.58 in interest in 1989 alone. Complaint ¶ 32. Accordingly, because the parties have "otherwise agreed," Bissell has no claim for relief under section 207 of the UCC, and this claim must be dismissed.

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8. MLPF&S argues that Article 9 of the UCC specifically excludes the transaction in question, that UCC section 9-207(2)(c) does not apply to the "interest, other profits or economic benefits" earned by MLPF&S from its use of plaintiff's collateral, and that Article 9 is preempted by the federal regulatory framework dealing with short sales transactions. However, for the purposes of this motion, the Court will assume that the UCC provision applies and is not preempted, because even if it does apply Bissell still fails to state a claim under the terms of the provision.

Appendix C

CONCLUSION

For the reasons set forth above, plaintiff's Second Amended Class Action Complaint is dismissed in its entirety with prejudice, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. Plaintiff's motion for class certification is denied as moot. The Clerk of the Court is directed to close the file in this case.

SO ORDERED.

Dated: New York, New York
August 14, 1996

s/ Allen G. Schwartz
ALLEN G. SCHWARTZ, U.S.D.J.

APPENDIX D — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK IN *RAIZY LEVITIN v. PAINEWEBBER, INC.* DATED JULY 9, 1996

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

95 Civ. 6508 (DC)

RAIZY LEVITIN, On Behalf of Herself and All Others Similarly Situated,

Plaintiff,

- against -

PAINEWEBBER, INC.,

Defendant.

OPINION

* * *

CHIN, D.J.

Raizy Levitin ("Levitin" or "plaintiff") brings this action on behalf of herself and all other persons who have conducted short sales through PaineWebber, Inc. ("PaineWebber" or "defendant") since August 15, 1992 alleging that PaineWebber, by purportedly misappropriating funds that its customers provided as collateral, engaged in securities fraud. In addition to the federal securities fraud claims, plaintiff and the putative class assert various state law claims. Defendant moves to

dismiss the complaint for failure to state a claim for securities fraud under section 10(b) of the Securities and Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. § 78j(b), and, if this claim is dismissed, to dismiss the remaining claims for lack of subject matter jurisdiction. Because the alleged fraud was not perpetrated "in connection with" the purchase or sale of securities within the meaning of the 1934 Act, PaineWebber's motion is granted.

BACKGROUND[1]

In 1994, Levitin entered into a margin agreement with PaineWebber, a registered broker-dealer. Through her PaineWebber margin account, plaintiff engaged in short sales of securities. In the typical short sale, the customer sells stock that he or she does not own. The customer usually covers the sale with stock borrowed from the broker. If the customer is able to purchase the stock later at a lower price to repay the stock to the broker, the customer will earn a profit equal to the difference between the sale price and the purchase price.[2] To secure the loan of stock, the customer is required to provide the broker with collateral in the form of cash or securities.[3]

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1. The facts alleged in the complaint are taken as true for purposes of this motion to dismiss.

2. The Securities and Exchange Commission ("SEC") has defined the term "short sale" as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." 17 C.F.R. § 240.3b-3.

3. For short sales of nonexempted securities, Regulation T requires that customers meet an initial margin requirement of 150% of the market value of the security being sold. 12 C.F.R. § 220.19(c). The New York

(Cont'd)

The proceeds of the short sale, which are applied toward the margin requirement, remain in the customer's account until the sale is covered.

The broker obtains the stock that it loans to the customer from its own reserves or by borrowing it from other brokers or other customers, as permitted by standard margin agreements. When the broker borrows the stock from external sources, the broker must secure the loan with collateral worth at least 100% of the market value of the securities borrowed. Regulation T, 12 C.F.R. § 220.16. The funds used to secure the loan of stock may be taken directly or indirectly from the account of the customer engaging in the short sale, and typically are generated by the short sale itself.

Where the broker has provided collateral to another broker or institution to secure the loan of securities, the borrowing broker typically receives a portion of any interest earned on the collateral, known as a "rebate." The borrowing broker does not usually pass any of the interest on to its customer, although an exception is sometimes made for large or professional customers.

In essence, the complaint alleges that PaineWebber uses its customers' assets, in the form of cash and stock collateral and proceeds of short sales, to earn interest and to obtain other financial benefits without notifying the customers of this practice or sharing the proceeds with them. Based upon these

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(Cont'd)
Stock Exchange (the "NYSE") imposes separate maintenance margin requirements for short sales. *See* NYSE Rule 431(c) ; *see also* Regulation T, 12 C.F.R. § 220.1(b)(2) (permitting exchanges to impose margin requirements above those set by the Federal Reserve Board).

allegations, Levitin and the putative class assert claims for securities fraud, breach of fiduciary duty, breach of trust, breach of implied covenants of good faith and fair dealing, and violation of Article 9 of the Uniform Commercial Code.

DISCUSSION

A. *Standard for Motion to Dismiss*

In ruling upon the motion to dismiss the complaint under Rule 12(b)(6), I must view the complaint in the light most favorable to Levitin, accepting all allegations contained in the complaint as true. *See Scheuer v. Rhodes*, 416 U.S. 232, 236, 94 S. Ct. 1683, 1686 (1974); *Annis v. County of Westchester*, 36 F.3d 251, 253 (2d Cir. 1994). All reasonable inferences are to be drawn in the plaintiff's favor, and the claims should not be dismissed unless it appears beyond doubt that the plaintiff can prove no set of facts in support of her claim that would entitle her to relief. *See Scheuer*, 416 U.S. at 236, 94 S. Ct. at 1686 (*citing Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S. Ct. 99, 102 (1957)); *Christ Gatzonis Elec. Contractor, Inc. v. New York City Sch. Constr. Auth.*, 23 F.3d 636, 639 (2d Cir. 1994).

B. *Securities Fraud Claims*

Levitin bases her securities fraud claims upon defendant's alleged violation of three rules promulgated under section 10(b) of the 1934 Act: Rule 10b-5, Rule 10b-10, and Rule 10b-16.

1. *Rule 10b-5*

To state a claim under section 10(b) and Rule 10b-5, the general securities fraud provision, a plaintiff must allege that

"in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 264 (2d Cir. 1993) *quoting Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61 (2d Cir. 1985)), *cert. denied*, 114 S. Ct. 1397 (1994) (internal quotations omitted); *accord Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995); *see Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986) ("To state a claim under Section 10(b), a complaint must allege material misstatements or omissions indicating an intent to deceive or defraud in connection with the purchase or sale of a security.") (*citing Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375 (1976)).

The alleged misrepresentation or omission must be made "in connection with the purchase or sale" of a security. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *see Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir.), *cert. denied*, 469 U.S. 884, 105 S. Ct. 253 (1984). To satisfy this requirement, the misrepresentation or omission must pertain to the securities themselves; allegations of fraud merely involving securities are not sufficient. *See Chemical Bank*, 726 F.2d at 943. In *Chemical Bank* the Second Circuit described the rationale for this requirement as follows:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions — to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or

> for a consideration known to the buyer not to be what it purports to be.

726 F.2d at 943. Many securities fraud claims have been dismissed because the alleged misrepresentation did not pertain to the securities involved in the purchase or sale. *See, e.g., Abrash v. Fox*, 805 F. Supp. 206, 208-09 (S.D.N.Y. 1992) (holding that misrepresentations must involve nature or quality of security); *Manufacturers Hanover Trust Co. v. Smith Barney, Harris Upham & Co.*, 770 F. Supp. 176, 181 (S.D.N.Y. 1991) ("Misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves cannot form the basis of a violation of Section 10(b) or Rule 10b-5.") (citations omitted); *Vigilant Ins. Co. v. C. & F. Brokerage Servs.*, 751 F. Supp. 436, 438 (S.D.N.Y. 1990) (to be actionable as securities fraud, "the misrepresentation must relate to the value of the security"); *see also Crummere v. Smith Barney, Harris Upham & Co.*, 624 F. Supp. 751, 755 (S.D.N.Y. 1985).

The holding in *Vigilant* is instructive here. *Vigilant* involved a NYSE specialist firm that satisfied its own delivery obligations with stock it borrowed from other brokerage houses through the assistance of the defendants, who served as middlemen or "finders." 751 F. Supp. at 437. The firm would provide cash collateral to the finders and, when the borrowed stock was returned, was supposed to receive its collateral plus an interest payment. *Id.* Claiming that the finders defrauded it of the interest payments, the firm sought to recover for securities fraud. *Id.* Although the fraud involved the borrowing of stock, Judge Duffy held that the alleged retention of plaintiff's interest was not perpetrated in connection with the purchase or sale of securities because it did not affect the investment value of the stock. *Id.* at 438.

Appendix D

In this case, Levitin does not allege that PaineWebber's short sale practices related in any way to the value of the securities sold by her or to the price that she received for selling those securities. Although the nondisclosure of the interest PaineWebber earned on its customer's funds may have affected the customer's decision to open an account with defendant, the interest is not part of the consideration received by the customer for the sale of securities. *See Saxe v. E.F. Hutton & Co.*, 789 F.2d 105, 108 (2d Cir. 1986). Nor does plaintiff allege that she relied upon PaineWebber's nondisclosure in deciding to conduct short sales of securities or in deciding what securities to sell.

The right to invest and earn interest on the collateral or proceeds of a short sale does not pertain to the securities, but is merely a term of the arrangement between the broker and its customer under which the broker conducts short sales for the customer. *Cf. Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985) (broker's misrepresentation that he would distribute sale proceeds in accordance with customer's instructions did not constitute securities fraud, as it did not induce purchase or sale of securities but merely concerned mechanics of sale). As in *Bosio*, the alleged nondisclosure at issue in this case pertains not to the sale of the securities or the value of the securities themselves, but to the terms of the relationship between the broker and the customer. Accordingly, the alleged nondisclosure does not constitute securities fraud in violation of section 10(b) and Rule 10b-5.

Plaintiff also seeks to base her securities fraud claim on PaineWebber's breach of its alleged fiduciary duty to its customers. The parties disagree as to whether PaineWebber owed a fiduciary duty to its customers to disclose the interest

earned on their funds.[4] Although a breach of fiduciary duty does not give rise to a securities fraud claim merely because it involves a securities transaction, *see Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 479-80, 97 S. Ct. 1292, 1304 (1977); *Field v. Trump*, 850 F.2d 938, 946-48 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012, 109 S. Ct. 1122 (1989), a breach of fiduciary duty may constitute securities fraud where the breach involves deception achieved through a misrepresentation or nondisclosure in connection with the purchase or sale of securities. *See Pross v. Katz*, 784 F.2d 455, 457-58 (2d Cir. 1986). Regardless of whether PaineWebber owed a fiduciary duty to its customers to disclose the fact that it earned interest on their funds, however, this claim must fail to the extent it relies on section 10(b) and Rule 10b-5, for the nondisclosure was not made in connection with the purchase or sale of securities, as discussed above.

As PaineWebber's failure to disclose that it earned interest on its customers' collateral and the proceeds of their short sales was not "in connection with" the purchase or sale of securities, plaintiff's securities fraud claim based upon Rule 10b-5 is hereby dismissed. Because I hold that Levitin has failed to meet the "in connection with" requirement, I need not reach defendant's arguments that plaintiff has failed to adequately plead the other elements of her securities fraud claim.

2. *Rule 10b-10*

The "confirmation rule," Rule 10b-10, requires broker-dealers to provide customers with a written confirmation at or

4. Defendant argues that its relationship with its customers is merely that of debtor and creditor; plaintiff claims that PaineWebber is her fiduciary based upon agency and trust principles.

before completion of a securities transaction. The confirmation must contain information such as the date and time of the transaction, whether the broker-dealer is acting as agent for the customer, and the amount of remuneration to be received by the broker-dealer. *See* 17 C.F.R. § 240.10b-10. Levitin claims that PaineWebber's nondisclosure of the interest it earns on its customers' collateral violates Rule 10b-10's requirement that the broker notify the customer of "[t]he source and amount of any other remuneration received or to be received by the broker in connection with the transaction." 17 C.F.R. § 240.10b-10(a)(2)(i)(D).

PaineWebber argues that plaintiff's claim should be dismissed because no private cause of action exists for a broker's failure to comply with Rule 10b-10. It is not clear whether a private right of action exists for violation of Rule 10b-10. *Cf. Arst v. Stifel, Nicolaus & Co.*, No. 95-3005, 1996 WL 312721, at *3-4 (10th Cir. June 11, 1996) (declining to recognize cause of action for failure to provide names of customers as required by Rule 10b-10(a)(7)(i) where conduct at issue was not prohibited by section 10(b) of 1934 Act). I need not resolve this issue, however, because even assuming that a private cause of action exists for violations of Rule 10b-10 Levitin has failed to state a claim under section 10(b) of the 1934 Act.

In assessing the scope of liability under the SEC regulations promulgated pursuant to section 10(b), courts are to follow the language of the enabling statute.[5] *See Central Bank of Denver,*

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5. Section 10(b) provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

(Cont'd)

N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439, 1446 (1994) ("[T]he private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."); *Ernst & Ernst*, 425 U.S. at 213-14, 96 S. Ct. at 1391; *Crane Co. v. American Standard, Inc.*, 603 F.2d 244, 249 n.11 (2d Cir. 1979); *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 949-50 (3d Cir. 1985), *cert. denied*, 474 U.S. 935, 106 S. Ct. 267 (1985) ("Since section 10(b) contains the 'in connection with' language, all rules stemming from it must also contain this limitation.") (citation omitted). Therefore, liability under Rule 10b-10 can only be imposed for conduct that violates section 10(b) of the 1934 Act. Because PaineWebber's alleged nondisclosures were not in connection with the purchase or sale of a security, they are not prohibited by the statute and, hence, cannot support a claim for securities fraud under section 10(b) of the 1934 Act. *See Arst*, 1996 WL 312721, at *4 (nondisclosures after sale were not in connection with purchase or sale of securities, and, therefore, defendants' conduct did not give rise to private cause of action even though it was proscribed by Rule 10b-10).

(Cont'd)

> commerce or of the mails, or of any facility of any national securities exchange —
>
> . . .
>
> (b) To use or employ, *in connection with the purchase or sale of any security* registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (emphasis added).

Accordingly, Levitin's claim based upon PaineWebber's failure to comply with the disclosure requirements of Rule 10b-10 must be dismissed, because the alleged nondisclosure was not in connection with the purchase or sale of a security within the meaning of the 1934 Act.

3. *Rule 10b-16*

Rule 10b-16 prohibits brokers from extending credit to customers in securities transactions without disclosing the terms of the extension of credit, including interest rates, the method of determining balances, and other charges resulting from the extension of credit. *See* 17 C.F.R. § 240.10b-16. Levitin alleges that PaineWebber's conduct violated Rule 10b-16's requirements concerning disclosure of, *inter alia*, finance charges, conditions under which annual interest rates can be imposed, rebates, methods of computing interest, methods of determining balances on which interest is to be charged and whether credit is to be given for credit balances in cash accounts, other charges resulting from the extension of credit, and the nature of the broker's interest in the collateral. *See* Cmplt. ¶ 43. As Levitin's complaint contains no factual allegations regarding finance charges, interest rates, methods of determining balances, or provision of credit for credit balances, however, these alleged violations of Rule 10b-16 cannot form the basis of Levitin's claim. The only facts that plaintiff alleges in support of this claim, and, hence, the only facts that I will consider in ruling on this motion, concern PaineWebber's nondisclosure of the interest it earns on its customers' collateral.

Although Rule 10b-16 does not create an express cause of action for violation of its provisions and the Second Circuit has declined to resolve the issue of whether an implied cause

of action exists, *see Zerman v. Ball*, 735 F.2d 15, 23 (2d Cir. 1984), other courts have recognized an implied cause of action under section 10(b) of the 1934 Act for violations of Rule 10b-16. *See, e.g., Angelastro*, 764 F.2d at 949-50; *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 539 (9th Cir. 1984); *Liang v. Dean Witter & Co.*, 540 F.2d 1107, 1113 n.25 (D.C. Cir. 1976); *Metzner v. D.H. Blair & Co.*, 689 F. Supp. 262, 267 (S.D.N.Y. 1988); *Slomiak v. Bear Stearns & Co.*, 597 F. Supp. 676, 677-81 (S.D.N.Y. 1984).

As with the other regulations promulgated under section 10(b) of the 1934 Act, however, a cause of action for violation of Rule 10b-16 can only be maintained where the claim stems from the enabling statute's prohibition of the use of deceptive and manipulative devices in connection with the purchase or sale of securities. *See Angelastro*, 764 F.2d at 946; *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1358 n.8 (11th Cir. 1985) (without deciding issue, court stated that "violations of Rule 10b-16 may give rise to a private cause of action under section 10(b) only to the extent that the violations arise out of the purchase or sale of securities"); *cf. Metzner*, 689 F. Supp. at 267 (holding that plaintiff stated claim for violation of Rule 10b-16 where it could be inferred that plaintiffs were misled into purchasing securities due to broker's violation of rule). Here, as PaineWebber's nondisclosures did not pertain to the purchase or sale of securities, Levitin cannot recover under section 10(b) for the alleged violations of Rule 10b-16.

CONCLUSION

As Levitin has failed to state a claim upon which relief may be granted under section 10(b) of the 1934 Act, her claims based upon that statute and the regulations promulgated

thereunder are dismissed. Because I have dismissed all of plaintiff's federal claims, and given the early posture of this case, I decline to exercise supplemental jurisdiction over the state law claims. *See* 28 U.S.C. § 1367(c)(3); *United Mine Workers of America v. Gibb*, 383 U.S. 715, 726, 86 S. Ct. 1130, 1139 (1966); *Castellano v. Board of Trustees of the Police Officers' Variable Supplements Fund*, 937 F.2d 752, 758 (2d Cir.), *cert. denied*, 502 U.S. 941, 112 S. Ct. 378 (1991).[6] Accordingly, the state law claims are dismissed as well.

SO ORDERED.

Dated: New York, New York
July 9, 1996

s/ Denny Chin
DENNY CHIN
United States District Judge

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6. Although Levitin states in her complaint that jurisdiction is also founded upon 28 U.S.C. § 1332, plaintiff has not pleaded any facts supporting diversity jurisdiction, such as her state of domicile or the amount in controversy.

APPENDIX E
SECTION 9-207 OF NEW YORK'S UNIFORM COMMERCIAL CODE

§ 9-207. Rights and Duties When Collateral Is In Secured Party's Possession

(1) A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument or chattel paper reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.

(2) Unless otherwise agreed, when collateral is in the secured party's possession

(a) reasonable expenses (including the cost of any insurance and payment of taxes or other charges) incurred in the custody, preservation, use or operation of the collateral are chargeable to the debtor and are secured by the collateral;

(b) the risk of accidental loss or damage is on the debtor to the extent of any deficiency in any effective insurance coverage;

(c) the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation;

(d) the secured party must keep the collateral identifiable but fungible collateral may be commingled;

(e) the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it.

(3) A secured party is liable for any loss caused by his failure to meet any obligation imposed by the preceding subsections but does not lose his security interest.

(4) A secured party may use or operate the collateral for the purpose of preserving the collateral or its value or pursuant to the order of a court of appropriate jurisdiction or, except in the case of consumer goods, in the manner and to the extent provided in the security agreement.

(L. 1962, c. 553.)

APPENDIX F - PERTINENT EXCERPTS FROM DEPARTMENT OF TREASURY REGULATIONS GOVERNING BOOK-ENTRY TREASURY BONDS, NOTES AND BILLS. 61 FR 43626, 43626-43627 (Aug. 23, 1996)

(Full Text Available on Westlaw at 1996 WL 475279)

A. Federal Preemption

First, 5 commenters questioned whether §§ 357.10(c) and 357.11(d) were intended to be a complete or limited preemption of a state's law if the state had not adopted Revised Article 8. As set forth in the March 4 release, the preemption in TRADES is limited. See the commentary in Appendix B. In order to clarify this issue, Treasury has adopted language in both §§ 357.10(c) and 357.11(d) suggested by a commenter to make the limited nature of the preemption clearer. This language provides that, if a state has not adopted Revised Article 8, that state's laws shall be viewed as though that state had adopted Revised Article 8.

APPENDIX G - PERTINENT EXCERPTS FROM THE MARKET REFORM ACT OF 1990, REPORT OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS. S. REP. NO. 101-300, 101ST CONGRESS, 2D SESS., AT P. 64 (May 22, 1990) (Full text available on Westlaw at 1990 WL 259302)

Some steps have been taken since the October 1987 crash towards harmonizing the state laws governing the transfer and pledge of securities.[231] However, given the cumbersome procedures involved in achieving uniformity through state-by-state amendments to laws governing the transfer and pledge of securities in the various states, the SEC has requested from Congress authority to take necessary action to harmonize inconsistent state laws which would impede the effective functioning of the clearance and settlement process.

Authority to facilitate the transfer and pledge of securities.—S. 648 would establish a framework through the SEC would be able to promulgate rules applicable to the

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[231] In January 1989, at the request of the SEC, the American Bar Associate Section on Corporate and Securities Law formed an Advisory Committee to study the need to harmonize state law governing the transfer and pledge of securities. The Advisory Committee includes representatives of the SEC, CFTC, OCC, CME, the Federal Reserve Bank of New York, the Treasury and state commercial law experts. The Committee has met several times in an effort to identify those areas in which the lack of uniform laws causes clearance and settlement problems and to develop solutions to these problems. The Advisory Committee has established subgroups to examine specific topics and is expected to prepare a draft interim report by June 1990.

transfer and pledge of securities, notwithstanding state laws. The Committee believes that S. 648 will give the SEC the ability to provide greater certaintly *[sic]* concerning the rights of leaders, borrowers and investors in securities. As a result, the clearance and settlement system will become more stable and efficient, thereby reducing the threat to the nation's financial system.

During the Committee's consideration of S. 648, concerns were raised about the appropriateness of providing a regulatory agency with the authority to override state law through rulemaking. Due to the critical importance of strengthening the clearance and settlement system, the Committee determined that it was appropriate to provide the SEC with limited authority in this area. The Committee believes that the authority granted to the SEC to preempt state law in S. 648 is carefully circumscribed so as to minimize the intrusive nature of the SEC actions. As Treasury Secretary Brady noted:

> [Treasury] did have concerns about this provision. However, changes were made to this section that largely addressed our concerns. First, two additional findings that constrain the exercise of SEC authority would be required for rulemaking. Second, the SEC, after consulting with Treasury and the Federal Reserve, would appoint a 15-member Advisory Committee to report to the SEC, and the SEC would have to give consideration to its recommendations. Third, the SEC would be specifically required to consult with and consider the views of the Secretary of the

> Treasury and the Federal Reserve. If the Secretary of the Treasury were to object, the Commission would have to consider all feasible alternatives and make explicit findings before adopting the rule.[232]

The Committee notes that, before adopting any rule or regulation which would have the effect of preempting state commercial law, the SEC would be required to make specific findings that (1) the rule is necessary and appropriate for the protection of investors or in the public interest, (2) that the safe and efficient clearance and settlement will be impeded absent a rule, and (3) that the benefits of the rule exceed the detriments. It should also be noted that, under existing section 25 of the Exchange Act, any state which is affected and which does not believe that SEC has met its burden of findings may challenge the SEC's action in federal court.

The authority granted in S. 648 is essentially an extension of previous Congressional policy in this area. In 1975 amendments to the Exchange Act regarding the establishment of a national clearance and settlement system, Congress in section 17A of the Exchange Act authorized the SEC to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities."

In addition, on a number of occasions in the past, Congress has determined to preempt state Uniform Commercial Code provisions in order to provide national

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[232] Letter of Nicholas F. Brady, [October 25, 1989), printed in 8 Hrg. 101-475, at 230.

standards in areas affecting interstate commerce.[233] Recognizing the need for federal standards to avoid contradictory state laws providing time periods for the availability of funds, the Expedited Funds Availability Act[234] provided that inconsistent state laws, "including the Uniform Commercial Code as in effect in [any] state," would be preempted.[235] The authority to override state Uniform Commercial Code provisions extended to rules of the Federal Reserve promulgated pursuant to the statute.[236] More recently, in adopting the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Congress authorized the Federal Deposit Insurance Corporation to act as a receiver and conservator of state chartered institutions, notwithstanding the law or Constitution of any State.[237] FIRREA also "preempts State law with respect to claims brought by the FDIC in any capacity against officers and directors of an insured depository institution." In

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[233] *See*, The Federal Bills of Lading Act, 49 U.S.C.A. sec. 81 *et seq.* (1976); the National Consumer Credit Protection Act, 18 U.S.C.A. secs. 1601 *et seq.* (1976); the Magnuson-Moss-Warranty-Federal Trade Commission Improvement Act, 15 U.S.C.A. sec. 2301 *et seq.* (1979).

[234] Contained in Title V of the Competitive Equality Banking Act, Pub. L. 100-86

[235] *Id.* Section 608(b).

[236] *See* Regulation CC, 12 C.F.R. 229 (1988).

[237] Pub. L. 101-73, 103 Stat. 183, sec. 212(a).

determining that FIRREA should preempt State laws in these and other areas, Congress concluded that the gains in efficiency provided by a uniform Federal policy outweighted *[sic]* state concerns in these carefully defined, limited and technical areas.

APPENDIX H - PERTINENT EXCERPTS FROM 136 CONG. REC. S13771-02, S13777 (SEPT. 25, 1990) (Full text available on Westlaw at 1990 WL 359769)

STATEMENT OF SENATOR DODD:

There was considerable discussion with respect to the provisions of the legislation relating to the transfer of securities. The legislation gives the SEC authority to adopt rules concerning the transfer of securities other than Government securities, where the SEC determines that the absence of Federal rules substantially impedes the safe and efficient operation of the national system for the clearance and settlement of securities transactions. This provision is explained in the respective Senate and House reports. Areas of special concern to the operation of the national system include: Choice of law rules for participants in the national system; when transfers on the books of a clearing corporation are effective; where clearing corporations may maintain securities certificates -- or uncertificated securities positions -- to facilitate settlement of transactions in non-U.S. securities; and when and how limited interests -- such as security interests -- in securities other than Government securities are created and perfected.

Before preempting State law, the SEC must make three specific findings: First, that the rule is necessary and appropriate for the protection of investors or in the public interest; second, that the safe and efficient clearance and settlement of securities will be impeded absent a rule; and third, that the benefits of the rule exceed the detriments. Further, before promulgating such a rule, the SEC must consult with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. If the Secretary

of the Treasury objects to the SEC's determination that promulgation of a rule is appropriate, the SEC must consider all feasible alternatives to the proposed rule. In addition, the statute requires the SEC to establish a 15-member advisory committee in order to benefit from the view of experts.

The compromise amendment contains a change to enhance State interests without sacrificing the goals of the legislation. It provides that any State may, within 2 years of the SEC's adoption of a rule under section 17A(f)(1) of the Exchange Act, enact a statute that specifically refers to the SEC rule and subsection 17A(f)(3) of the Exchange Act and Establish a provision that differs from that applicable under the SEC's rule. Any such State statute would be effective prospectively from the date of its adoption.

This change is designed to balance State interests against the need for efficient and safe operation of the national system for clearance and settlement of securities transactions. It is intended to preserve State law as the principal source of rules for commercial transactions, while providing the SEC the authority it needs related to the transfer of securities -- including limited interests in securities, such as security interests in securities, and choice of law or related conflict of law provisions -- that substantially impede the safe and efficient operation of the national system for the clearance and settlement of securities transactions. By providing the States with the ability to nullify and *[sic]* SEC rule, this provision permits the relevant State authorities to evaluate whether an SEC rule effectively represents that State's individual interests. Of course, in the event a State law is enacted which differs substantially from an SEC rule to the detriment of the efficient operation of the

national system, congressional action to address those detriments would be possible.

APPENDIX I - JULY 12, 1979 SEC NO-ACTION LETTER RE INTEREST TO CLIENTS ON SHORT SALES

SEC LETTER

1934 Act/s 15(C) Rule 15c3-3

July 12, 1979

Publicly Available August 12, 1979

Mr. Norman P. Singer
1383 Canterbury Way
Rockville, Maryland 20854

Dear Mr. Singer:

This is in response to your letter of June 6, 1979, which follows up my previous letter of June 4, 1979, to Senator Sarbanes. In it, you question "why interest should be paid by the client to a broker, and no interest in turn be paid to the client, when the client goes short and is himself the lender of the short sales!" [emphasis in original]

As stated in our June 4 letter, a member firm of the New York Stock Exchange, Inc. ("NYSE"), may pay interest in certain circumstances on customer credit balances if funds are being held for the purpose of engaging in securities transactions. In addition, with regard to stock loans made in connection with short sales of securities, borrowing member firms may pay a premium and lending members firms may pay interest pursuant to NYSE Rule 153. Rule 153,

however, reaches transactions between NYSE member firms and does not relate to transactions between a member firm and its customers.

Inasmuch as no NYSE or Commission rule prohibits or explicitly mandates the payment of interest on customer credit balances and monies generated from the lending of customer securities, the payment of such interest is a matter for negotiation between the customer and the broker-dealer.

If you have any further questions, please contact me.

Sincerely,

Marc L. Weinberg
Staff Attorney

Securities and Exchange Commission

APPENDIX J - DECEMBER 2, 1994 LETTER FROM FEDERAL RESERVE BOARD TO PLAINTIFFS' COUNSEL. REPRINTED AT PAGE A447 OF THE RECORD APPENDIX TO THE BISSELL APPEAL BELOW AND PAGE A173 OF THE RECORD APPENDIX TO THE LEVITIN APPEAL.

Board of Governors
of the
Federal Reserve System
Washington, D.C. 20551

Division of Banking
Supervision and Regulation

December 2, 1994

Irving Malchman, Esq.
Kaufman Malchman Kirby & Squire
949 Third Avenue
New York, New York 10022

Dear Mr. Malchman:

This responds to your letter of November 14, 1994. You are concerned with Regulation T's impact on the issue of whether a broker-dealer must pay its customer interest on short sale proceeds. A copy of Regulation T is enclosed for your convenient reference.

Regulation T does not regulate the payment of interest by either a broker-dealer or its customer. The only references to interest can be found in sections 220.4(f) and

220.6(b) of the regulation. These sections simply acknowledge that the interest charges imposed by the broker-dealer may be debited to the margin account and interest payments due to the customer may be credited to the special memorandum account. You may also wish to refer to section 220.18(c) of Regulation T, which requires a margin of 150 percent for the short sale of a nonexempted equity security.

Yours truly,

Scott Holz
Senior Attorney

Enclosure

No. 98-1013

Supreme Court, U.S.
FILED
JAN 22 1999
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

RAIZY LEVITIN, *et al.*,

Petitioners,

vs.

PAINEWEBBER, INC.,

Respondent.

LOUIS G. BISSELL, JR.,

Petitioner,

vs.

MERRILL LYNCH & COMPANY, INC., and
MERRILL LYNCH PIERCE, FENNER & SMITH, INC.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RESPONDENTS' JOINT BRIEF IN OPPOSITION

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QUESTION PRESENTED

Should the Court grant certiorari on an issue of federal preemption when:

(1) petitioners do not contend that the court of appeals failed to state the law of preemption correctly, and can point to no conflict with the decision of another United States court of appeals or a state court of last resort on the same matter;

(2) the court of appeals correctly applied the law of preemption to the facts before it;

(3) in one of the two cases at issue, *Levitin v. PaineWebber*, an opinion by the Court would be purely advisory because it would not affect the dismissal of petitioner's federal claims below, and there is no independent basis of federal jurisdiction for petitioner's state law claims; and

(4) in the other of the two cases at issue, *Bissell v. Merrill Lynch*, any opinion also would be advisory because both the court of appeals and the district court, in rulings not challenged here, found that petitioner and respondent reached an agreement negating any right petitioner might otherwise have under U.C.C. § 9-207(2)(c), even if that provision of state law were *not* preempted?

STATEMENT PURSUANT TO RULE 29.6

The following are the parent companies or nonwholly owned subsidiaries of respondents:

The parent of respondent Merrill Lynch, Pierce, Fenner & Smith Incorporated is Merrill Lynch & Co., Inc. The only nonwholly owned subsidiary of Merrill Lynch, Pierce, Fenner & Smith Incorporated is Merrill Lynch Professional Clearing Corp.

The parent of respondent PaineWebber Incorporated (identified in the caption as "PaineWebber, Inc.") is Paine Webber Group Inc. There are no nonwholly owned subsidiaries of PaineWebber Incorporated.

TABLE OF CONTENTS

	Page
Question Presented	i
Statement Pursuant to Rule 29.6	ii
Table of Contents	iii
Table of Cited Authorities	v
Statement of the Case	1
A. *Levitin v. PaineWebber*	1
B. *Bissell v. Merrill Lynch*	2
C. The Consolidated Appeals	4
Reasons for Denying the Writ	6
Argument	7
I. The Petition Does Not Raise Any Issue Worthy Of The Court's Consideration.	7
A. The Petition Seeks Review Solely of the Application of a Properly Stated Rule of Law.	7
B. There is No Conflict of Decisions.	7
II. The Court Of Appeals Properly Applied Preemption.	10

Contents

Page

III. Any Opinion Of The Court On The Question Presented In The Petition Would Be Advisory. 14

A. Any Opinion on Preemption Would Merely Be Advisory as to *Levitin*. 14

B. The U.C.C. § 9-207(2)(c) Claim in *Bissell* Fails on State Law Grounds. 15

Conclusion 16

TABLE OF CITED AUTHORITIES

Page

Cases:

Dahl v. Charles Schwab & Co., 545 N.W. 2d 918 (Minn.), *cert. denied*, 117 S. Ct. 176 (1996) 10

Estate of Braunstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 657 N.Y.S. 2d 12 (N.Y. App. Div.), *app. dismissed*, 686 N.E. 2d 1366, *app. denied*, 691 N.E. 2d 630 (N.Y. 1997), *cert. denied*, 118 S. Ct. 1798 (1998) 9, 10

Field v. Trump, 850 F.2d 938 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989) 15

Guice v. Charles Schwab & Co., 674 N.E. 2d 282 (N.Y. 1996), *cert. denied*, 117 S. Ct. 1250 (1997) 10, 11

Orman v. Charles Schwab & Co., 688 N.E. 2d 620 (Ill. 1997), *cert. denied*, 118 S. Ct. 1518 (1998) 10

Phillips v. Washington Legal Foundation, 118 S. Ct. 1925 (1998) 8

Rosenfeld v. Bear, Stearns & Co., 655 N.Y.S. 2d 473 (N.Y. App. Div.), *app. dismissed*, 684 N.E. 2d 282, *app. denied*, 688 N.E. 2d 1382 (N.Y. 1997) .. 10

SEC v. Lehman Bros., Inc., 157 F.3d 2 (1st Cir. 1998) 7, 8

Cited Authorities

Page

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The Monrosa v. Carbon Black Export, Inc., 359 U.S. 180 (1959) 14, 15

Statutes:

15 U.S.C. § 78cc 8

15 U.S.C. § 78j(b) 1, 2, 5, 6, 14, 15

15 U.S.C. § 78o(c)(3) 9

15 U.S.C. § 78o(h)(1) 11

N.Y. [UCC] Law § 9-207(2)(c) ..... *passim*

National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 (1996) 11

Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 (1998) 11

Rules:

Fed. R. Civ. P. 12(b)(6) 2, 4

United States Supreme Court Rule 10 7

Cited Authorities

Page

Other Authorities:

12 C.F.R. § 220.5(b)(2) 3

12 C.F.R. § 220.16 3

Adoption of Rule 15c3-2, Exchange Act Release No. 34-7325, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000 (May 27, 1964) 12, 13

Adoption of Rule 15c3-3, Exchange Act Release No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,083 (Nov. 13, 1972) 10, 11

New York Stock Exchange Rule 431(e)(1), NYSE Guide (CCH) ¶ 2431(e)(1) (1994) 4

Proposed Rule 15c3-2, Exchange Act Release No. 34-7266, [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,978 (Mar. 12, 1964) 12

Proposal to Adopt Rule 15c3-3, No. 34-9622, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 (May 31, 1972) 13

SEC, Report of Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 393-94 (1963) 12

STATEMENT OF THE CASE

Petitioners' "Statement of the Facts" is materially incomplete.

Petitioners have filed a joint petition seeking a writ of certiorari to the United States Court of Appeals for the Second Circuit on two separate, but related cases — *Levitin v. PaineWebber, Inc.*, 159 F.3d 698 (2d Cir. 1998) ("*Levitin II*") (Pet. App. A), and *Bissell v. Merrill Lynch & Co.*, 157 F.3d 138 (2d Cir. 1998) ("*Bissell II*") (Pet. App. B). Although the cases were heard together on appeal and affirmed in essentially one opinion in *Levitin II*, the facts and procedural history of each case, which are not set forth in the petition, are relevant to the Court's consideration.

A. *Levitin v. PaineWebber*

Petitioner Levitin was a customer of PaineWebber who engaged in short sales. In 1995, Levitin filed a class action on behalf of herself and a putative class of other customers who conducted short sales through PaineWebber. The complaint alleged claims of fraud under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), as well as a variety of state law claims, including a claim that PaineWebber had violated New York's version of Section 9-207(2)(c) of the Uniform Commercial Code (the "UCC"), N.Y. [UCC] Law § 9-207(2)(c). The complaint's first and core contention was that PaineWebber had committed federal securities fraud by failing to notify its customers of its historical and regulated practice, in common with that of the entire brokerage industry, of retaining the interest and profits it earned on the collateral maintained on account in connection with customer short sales.[1] Secondarily, petitioner alleged that

1. In a regular short sale, the collateral consists of the proceeds of the short sale plus the additional margin required by federal regulation, exchange rules and house rules of the brokerage firm.

the retention of those earnings by PaineWebber constituted a violation of state law, including the UCC. The complaint alleged no facts supporting diversity jurisdiction.

Upon motion by PaineWebber under Fed. R. Civ. P. 12(b)(6), the district court dismissed the Section 10(b) claims, holding that the alleged fraud was not "in connection with" the purchase or sale of securities. The district court did not reach Levitin's UCC or other state law claims, but instead dismissed those claims for lack of any independent basis of original jurisdiction. *Levitin v. PaineWebber, Inc.*, 933 F. Supp. 325, 331, n.6. (S.D.N.Y. 1996) ("*Levitin I*") (Pet. App. 62a, n.6). Judgment was entered for PaineWebber, and Levitin appealed.

B. *Bissell v. Merrill Lynch*

Petitioner Bissell was a customer of Merrill Lynch who, like Levitin, also had engaged in short sales. In 1993, Bissell filed a class action, purportedly on behalf of himself and all similarly situated customers of Merrill Lynch, alleging a Section 10(b) claim and several state law claims, including a claim that Merrill Lynch's conduct violated U.C.C. § 9-207(2)(c). Bissell adequately alleged both federal question and diversity jurisdiction, providing a basis for the district court's jurisdiction over both his federal *and* state claims.

As in *Levitin*, Bissell's core allegation was that Merrill Lynch had unlawfully retained and, in violation of Section 10(b), failed to disclose its earnings on its use of the collateral in connection with customer short sales. Similarly, Bissell alleged that Merrill Lynch's conduct constituted violations of New York law, including U.C.C. § 9-207(2)(c). In *Bissell*, however, both the district court and the court of appeals found that Bissell actually had *otherwise agreed* with Merrill Lynch concerning the sharing of the earnings in question, negating

any claim under U.C.C. § 9-207(2)(c). *Bissell v. Merrill Lynch & Co.*, 937 F. Supp. 237, 248-49 (S.D.N.Y. 1996) ("*Bissell I*") (Pet. App. 47-48a); *Bissell II*, 157 F.3d at 138 (Pet. App. 23a).[2]

There is another difference between *Levitin* and *Bissell*. Unlike the "regular" short sales alleged in *Levitin*, the sales in *Bissell* were short sales "against the box". *See Bissell I*, 937 F. Supp. at 240-41 (Pet. App. 26-29a); *Bissell II*, 157 F.3d at 138. (Pet. App. 23a). In a short sale against the box, often a tax-driven transaction, the short seller owns at least an equal number of shares of the same stock issue (the "long position") that he sells short. *See Bissell I*, 937 F. Supp. at 240 (Pet. App. 26-27a). A short sale "against the box" is subject to different regulatory and margin requirements from those governing "regular" short sales. For example, a short sale "against the box" is deemed to be a long sale under Federal Reserve Board Regulation T and free of federal initial margin requirements. *See* 12 C.F.R. § 220.5(b)(2). However, as in a regular short sale, a short sale "against the box" requires the seller to borrow the stock from his brokerage firm for delivery to the buyer. That stock loan must be collateralized 100% in cash or cash equivalents. *See* Regulation T, 12 C.F.R. § 220.16.[3]

2. U.C.C. § 9-207(2)(c) provides:

> *Unless otherwise agreed*, when collateral is in the secured party's possession . . . the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation.

N.Y. [UCC] Law § 9-207(2)(c) (McKinney 1990) (emphasis added).

3. In a short sale "against the box," the collateral consists of the proceeds of the short sale and the short seller's long position "in the

(Cont'd)

Upon motion by Merrill Lynch under Fed. R. Civ. P. 12(b)(6), the district court, relying in part on the decision in *Levitin I*, dismissed Bissell's securities fraud claims for failure to state a claim of fraud "in connection with" the purchase or sale of a security. The court also dismissed each of Bissell's state law claims (including the UCC claim, on the ground that Bissell and Merrill Lynch had *otherwise agreed* to share earnings).[4] As in *Levitin*, the district court did not reach the issue of federal preemption. *Bissell I*, 937 F. Supp. 237, 248-49 (S.D. N.Y. 1996) (Pet App. 47-48a). Judgment was entered for Merrill Lynch, and Bissell appealed.

C. The Consolidated Appeals

Appeals were consolidated in *Levitin* and *Bissell* and argued together before the same panel of the court of appeals. The court issued its primary opinion in *Levitin*, and on the same date an opinion in *Bissell* that briefly noted the factual differences between the two cases and held that neither would prevent Bissell's claims from being dismissed for the reasons stated in *Levitin II*. *See Bissell II*, 157 F.3d at 138-39 (Pet. App. 23a).

(Cont'd)

box." Moreover, unlike a regular short seller, the short seller "against the box" may borrow up to 95% of the proceeds against the security of the long position, repayable when the seller covers his short position. *See* New York Stock Exchange Rule 431(e)(1), NYSE Guide (CCH) ¶ 2431(e)(1) (1994). The short seller is charged interest on such loan by his brokerage firm.

4. Pursuant to that agreement with Merrill Lynch, Bissell received over $44,000 in 1989 alone. *See Bissell I*, 937 F. Supp. at 240-41, 248-49 (Pet. App. 29a, 48a). Petitioners do not challenge the lower courts' findings that Bissell had "otherwise agreed" with Merrill Lynch regarding the proceeds of the short sale, thus placing him outside the terms of U.C.C. § 9-207(2)(c).

The court in *Levitin II* affirmed the district court's dismissal of petitioner's federal securities fraud claim, but on different grounds from those articulated by the lower court. First and foremost, it held that the element of deception, a necessary ingredient of any Section 10(b) claim, was missing; as a matter of law, the appeals court ruled, any "reasonable investor" would have to know that collateral could produce income or other financial benefits, and thus the customer could not be deceived by non-disclosure of the brokerage firm's traditional practice of retaining these gains for its own benefit. *Levitin II*, 159 F.3d at 702-04 (Pet. App. 7-11a).[5] Next, the court of appeals held that, to the extent petitioner's Section 10(b) claim could be construed as a failure to alert petitioner to facts allegedly giving rise to a state law remedy under the UCC, the claim was additionally deficient because any such right under the UCC was preempted through operation of the extensive federal regulation of short sales and margin transactions. *See id.* at 704-07 (Pet. App. 11-19a).[6] Finally, to the extent that petitioner's federal claim of fraud might be construed as alleging that PaineWebber failed to disclose that it would negotiate with large customers to remit a portion of its earnings — *e.g.*, as Merrill Lynch had done with Bissell — the court of appeals found that claim to be deficient because petitioner had not alleged that she was a large customer who could have negotiated such a remittance in any event. *See id.* at 707-08 (Pet. App. 20-21a).

On the authority of *Levitin II*, the court of appeals affirmed the dismissal of the complaint in *Bissell*, but specifically noted in *Bissell II* that, as the district court had found, Bissell had been able to negotiate his own agreement with Merrill Lynch concerning a sharing of earnings from his short sale collateral:

---

5. Neither petitioner seeks review of this holding.

6. The preemption portion of this ruling is the sole issue on which review is sought.

> Bissell was a large trader who was able to *negotiate* a remittance of the earnings realized by appellees [Merrill Lynch] on the shares he posted as collateral.

Bissell II, 157 F.3d at 138-39 (Pet. App. 23a; emphasis added). Bissell does not challenge this finding. (Pet. 13, n.4).

REASONS FOR DENYING THE WRIT

1. The petition does not raise any question warranting the Court's review on a writ of certiorari. The petition points to no conflict between the decisions below and any decision of any other United States court of appeals or state court of last resort. Nor does it challenge the court of appeals' articulation of the governing principles of the law of preemption. The petition merely disputes the application of the properly stated law governing federal preemption to two particular sets of facts. Finally, the petition does not raise any substantial argument that the decisions below conflict with any controlling precedent of this Court.

2. Moreover, the court of appeals' application of well-settled preemption principles *was* correct. Petitioners' state law claims, if credited, would rewrite a detailed federal regulatory scheme and impermissibly alter its intended economic effects.

3. In any event, the petition should be denied because an opinion of the Court on the preemption issue would not affect either of the dismissals below. As to petitioner Levitin, the court of appeals' unchallenged finding that there was no deception as a matter of law is fatal to petitioner's Section 10(b) claim in all its forms, and because there exists no independent basis for jurisdiction over petitioner's state law claims, dismissal of the complaint was unarguably proper. Similarly, any opinion on preemption would not alter the dismissal and judgment in

Bissell. The finding of the court of appeals — unchallenged in the petition — that petitioner Bissell "was able to negotiate a remittance of the earnings" in question, *i.e., otherwise agreed* with respondent Merrill Lynch, renders his UCC claim academic at this juncture of the litigation.

ARGUMENT

I.

THE PETITION DOES NOT RAISE ANY ISSUE WORTHY OF THE COURT'S CONSIDERATION.

A. The Petition Seeks Review Solely of the Application of a Properly Stated Rule of Law.

Rule 10 of this Court makes clear that "[a] petition for a writ of certiorari is rarely granted when the asserted error consists of . . . the misapplication of a properly stated rule of law." The petition does not dispute that the court of appeals properly stated the law governing federal preemption. In fact, the petition cites to the same authorities and standards that the court of appeals relied upon in articulating the legal principles applicable to preemption. *Compare* Pet. 7 *with Levitin II*, 159 F.3d at 705 (Pet. App. 14a). The petition disputes only the court of appeals' application of properly stated preemption principles.

B. There is No Conflict of Decisions.

In its attempt to manufacture a conflict of decisions, the petition refers generally to inapposite authorities while ignoring cases where this Court recently declined review of similar claims. Most notably, the petition suggests that the Second Circuit's decision is at odds with the First Circuit's analysis in *SEC v. Lehman Bros., Inc.*, 157 F.3d 2 (1st Cir. 1998). There is

no such conflict. In *Lehman Brothers*, the SEC had sought a preliminary injunction in an enforcement action. Lehman objected on the grounds that the attached assets were subject to its prior valid security interest. Granting the injunction, the district court found that Lehman was not a bona fide purchaser under New York's UCC. *See SEC v. Pinez*, 989 F. Supp. 325, 339-44 (D. Mass. 1997), *rev'd sub nom., SEC v. Lehman Bros., Inc.*, 157 F.3d 2 (1st Cir. 1998). On appeal, both the SEC and Lehman agreed that the question of whether Lehman was a "bona fide purchaser" was governed by U.C.C. Article 8. The First Circuit found that there was no conflict between Article 8 and the lien provisions of Section 29 of the Exchange Act, 15 U.S.C. § 78cc, which void fraudulent securities contracts. *See Lehman Bros.*, 157 F.3d at 7-9. As the Second Circuit noted in *Levitin II,* Article 8, unlike the general language of Article 9, is explicitly aimed at the securities transfer process. *Levitin II*, 159 F.3d at 704, n.9 (Pet. App. 13a, n.9). The undisputed and intended application of U.C.C. Article 8 to securities transfers, unlike the application of U.C.C. § 9-207 to detailed margin requirements, did not conflict with any federal regulatory scheme.

The petition also cites the Court's recent decision in *Phillips v. Washington Legal Foundation*, 118 S. Ct. 1925 (1998), as a basis for granting a writ in this matter. In *Phillips*, the Court found a property interest for purposes of the Fifth Amendment Takings Clause in the common law principle that "interest follows principal." *Id.* at 1930 (Pet. 4). No conflict between state and federal law was asserted in that case.[7]

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7. Moreover, even the state law principles at issue in *Phillips* do not apply here. The parties in *Phillips* had stipulated that "the principal held in IOLTA trust accounts is the 'private property' of the client . . . *freely available* to the client on demand." *Id.* at 1929 (emphasis added). In the instant litigation, the short sale collateral was not "freely available [to petitioners] on demand." To the contrary, collateral of a short sale

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The petition also ignores a line of preemption cases in which state appellate courts have addressed claims similar to the one at bar. In *Estate of Braunstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 657 N.Y.S. 2d 12 (N.Y. App. Div.), *app. dismissed*, 686 N.E. 2d 1366, *app. denied*, 691 N.E. 2d 630 (N.Y. 1997), *cert. denied*, 118 S. Ct. 1798 (1998), for example, petitioners brought state common law claims seeking return of interest or other profits earned by securities broker-dealers on customer free credit balances. The New York appellate court held that these claims were preempted, finding that a federal regulatory scheme consisting of many of the provisions at issue here[8] would be "severely compromised" if securities brokers were compelled to pay interest on funds that they were otherwise free, under federal regulation, to use in their businesses. *See Estate of Braunstein*, 657 N.Y.S. 2d at 13. This Court denied certiorari in that case less than a year ago.[9]

(Cont'd)
must remain in place with the brokerage firm until the short position is closed. (In case of a short sale "against the box," 95% of the proceeds may be borrowed by the short seller, who pays interest on such loans. *See supra* note 3.) Only after the short position is closed does a short seller receive a portion of the collateral, if any, free and clear, assuming there is an excess over the amount needed to effect the covering transaction.

8. The court in *Estate of Braunstein* relied upon the same SEC rules relating to use of customer credit balances, adopted pursuant to the Commission's authority under 15 U.S.C. § 78o(c)(3), that are at issue in this case. Because the customer credit balances in *Estate of Braunstein* were not encumbered by a security interest in a short position and were thus the unfettered property of the customers, however, the additional SEC interpretations and Federal Reserve Board regulations at issue here were not implicated.

9. The Court has also denied certiorari on three other occasions in the past two terms in cases where Exchange Act regulations led the

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II.

THE COURT OF APPEALS PROPERLY APPLIED PREEMPTION.

The petition's sole contention is that the court of appeals incorrectly applied undisputed principles of preemption law. In fact, the preemption of U.C.C. § 9-207 by federal regulation was articulated properly and in great detail by the Second Circuit in its opinion in *Levitin II*. The federal regulatory scheme governing short sales, margin lending, and use of customer funds by brokers is "pervasive," including disclosure requirements, restrictions on extensions of credit, and restrictions on and permission for use of customer assets, including short sale collateral, in the brokerage business. *See Levitin II*, 159 F.3d at 700-01, 703 n.6, 705-07 (Pet. App. 4a-5a, 10a n.7, 14a-19a). Short sales and margin lending are extensively regulated both by the SEC and by the Federal Reserve Board, and brokerage firms must remain in continuous compliance with SEC rules relating to custody and use of customer funds.[10]

(Cont'd)
highest court of a state to find preempted various common law claims brought against securities brokerage firms. *See Orman v. Charles Schwab & Co.*, 688 N.E. 2d 620 (Ill. 1997), *cert. denied*, 118 S. Ct. 1518 (1998); *Guice v. Charles Schwab & Co.*, 674 N.E. 2d 282 (N.Y. 1996), *cert. denied*, 117 S. Ct. 1250 (1997); *Dahl v. Charles Schwab & Co.*, 545 N.W. 2d 918 (Minn.), *cert. denied*, 117 S. Ct. 176 (1996). The New York courts decided *Estate of Braunstein* and *Rosenfeld v. Bear, Stearns & Co.* on the authority of *Guice*. *See Rosenfeld v. Bear, Stearns & Co.*, 655 N.Y.S. 2d 473, 473-74 (N.Y. App. Div.) (settlement of class action involving stock lending approved over objections of, among others, petitioner Bissell on the grounds that, *inter alia*, the likelihood of success on the merits was highly questionable in light of the defendants' pending motion to dismiss on preemption grounds), *app. dismissed*, 684 N.E. 2d 282, *app. denied*, 688 N.E. 2d 1382 (N.Y. 1997).

10. The SEC asserted, in adopting Rule 15c3-3, that it intended the Rule to be "comprehensive" and uniform in its application. *See*
(Cont'd)

Petitioners' argument that U.C.C. § 9-207(2)(c) and these federal regulations are not in conflict is wrong. Under § 9-207(2)(c), an agreement between the pledgor (here, the short seller) and his or her pledgee (here, the brokerage firm) is necessary to permit the latter to keep all or any part of its earnings from the use of the collateral. On the other hand, under SEC regulations a brokerage firm may use such funds — along with other customer funds — for its own exclusive benefit under Rule 15c3-3 without prior customer permission or agreement, and *the customer* must negotiate for the added benefit of earning interest on collateral. The court of appeals properly recognized that this distinction in the default rules has a profound economic impact on the business of short selling:

> [r]egulation by the states would directly affect the very value of security posted pursuant to federal margin requirements. A secured lender who may retain earnings on collateral has more valuable security than a lender who must remit to the customer interest on the collateral.

(Cont'd)

Adoption of Rule 15c3-3, Exchange Act Release No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,083 at 82,346 (Nov. 13, 1972). This determination is clearly in line with numerous acts of Congress aimed at providing greater uniformity in the securities industry nationwide. *See, e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 (1998) (preempting certain state law causes of action arising out of securities markets); National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 (1996) (adding, *inter alia*, a new section 15(h) to the Exchange Act, 15 U.S.C. § 78o(h)(1), prohibiting states from regulating certain aspects of broker-dealers' businesses, including "capital, custody, [and] margin" requirements); *Guice, supra*, 674 N.E. 2d at 286-88, 289-90 (describing 1975 amendments to Exchange Act, and 1994 SEC regulations thereunder, as intended to create a "national market system for securities and a national system for the clearance and settlement of securities transactions").

Levitin II, 159 F.3d at 706 (Pet. App. 17a). Petitioners cite nothing to support their challenge to this critical finding. *See* Pet. 12.

The court of appeals' reading of SEC regulations is confirmed by SEC No-Action letters which point out that a brokerage firm *may* agree — but is *not* required — to share its earnings from short sale collateral. *See Levitin II*, 159 F.3d at 701, 703 n.7, 706-07 & n.12 (collecting SEC statements) (Pet. App. 5a, 10a n.7, 18a & n.12).[11] It is further supported by the SEC Releases accompanying the promulgation of the rules themselves.[12] Applying U.C.C. § 9-207(2)(c) to short sales would

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11. Contrary to petitioners' suggestion, the SEC No-Action letters cannot be read to support the proposition that the use of short sale collateral is governed by state law. Had that been the SEC's position, the letters would have said as much — *e.g.*, "absent agreement, any profits earned on the collateral belong to the customer." Instead, in response to customers who were seeking the earnings on collateral for themselves, the SEC letters state that the sharing of those earnings is a matter for negotiation — *i.e.*, that the customer must take *affirmative steps* to bargain for some or all of the interest to be earned on her collateral.

12. *See Bissell I*, 937 F. Supp. at 246-47 ("the relationship between the broker-dealer and the customer [with respect to credit balances] *is that of creditor-debtor*" (*quoting Adoption of Rule 15c3-2*, Exchange Act Release No. 34-7325, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000 at 81,668 (May 27, 1964) (emphasis added by the court))) (Pet. App. 43a). *Accord Proposed Rule 15c3-2*, Exchange Act Release No. 34-7266, [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,978 at 81,622 (Mar. 12, 1964). In a comprehensive 1963 study of the securities industry, the SEC recognized that customer credit balances (including collateral for short sales) "generally . . . can be used interest-free [footnote omitted]." *See SEC, Report of Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 393-94 (1963). Indeed, in enacting the disclosure provisions of Rule 15c3-2 the (Cont'd)

stand SEC regulations and industry practices on their head, requiring the payment of such earnings to the short seller unless he or she has waived the receipt of the earnings or a portion thereof in a prior agreement with the brokerage firm.

As the court of appeals noted, the SEC has generally followed a "policy of relying on competition to determine the economics of broker-client relationships." *Levitin II*, 159 F.3d at 707 (Pet. App. 18a). That policy would be frustrated by subjecting federally mandated collateral requirements and federally permitted uses of funds to state laws redirecting the benefits from such uses. And, as the court of appeals recognized, "Levitin's argument is not limited to state regulation that can be varied by private contract." *Levitin II*, 159 F.3d at 706, n.11 (Pet. App. 16a, n.11). Particular parties can always contract out of the default rule, and there is nothing in federal law or policy to prevent them from so doing; indeed, petitioner Bissell and respondent Merrill Lynch did just that. *See Bissell I*, 937 F. Supp. 237, 248-49 (Pet. App. 48a); *Bissell II*, 157 F.3d at 138-39 (Pet. 23a).

(Cont'd)

following year, the SEC rejected an earlier version of the Rule that would have required disclosure of whether or not interest would be paid on customer credit balances. *See Adoption of Rule 15c3-2*, ¶ 77,000 at 81,668. When the SEC revisited the issue in 1972 to enact Rule 15c3-3, it considered but ultimately rejected the approach of requiring free credit balances to be held in segregated trust accounts, explaining that it "sought to avoid freezing the liquid resources of the securities industry or *depriving it of business opportunities in areas, such as margin lending, where it has traditionally played a significant and constructive role.*" *Proposal to Adopt Rule 15c3-3*, No. 34-9622, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 at 81,729-30 (May 31, 1972) (emphasis added).

III.

ANY OPINION OF THE COURT ON THE QUESTION PRESENTED IN THE PETITION WOULD BE ADVISORY.

Where an opinion of the Court plainly would not affect the outcome of the action on remand, certiorari should not be granted. *See The Monrosa v. Carbon Black Export, Inc.*, 359 U.S. 180, 181 (1959). For separate but similar reasons, resolution of the preemption question would not affect the outcome of either of these cases, and the Court should accordingly decline to issue an advisory opinion in either *Levitin* or *Bissell*.

A. Any Opinion on Preemption Would Merely Be Advisory as to *Levitin*.

Certiorari should be denied in *Levitin v. PaineWebber* because granting review would result, at most, in an advisory opinion that would not affect the dismissal of petitioner Levitin's claims below.

The court of appeals' discussion of preemption in the *Levitin* opinion was prompted solely by its consideration of an argument asserted first at oral argument on appeal — namely, that by failing to disclose its retention of earnings on collateral, PaineWebber had failed to alert petitioner to facts giving rise to the deprivation of her rights under New York law, and thus violated Section 10(b) of the Exchange Act by virtue of the so-called "loss-of-state-law-remedies" doctrine. *Levitin II*, 159 F.3d at 704 (Pet. App. 6a, 11a-12a).

For at least two reasons wholly unrelated to preemption, however, petitioner has no "loss-of-state-law-remedies" Section 10(b) claim to assert. First, the doctrine is a narrow one, limited to cases where the defendant's deception deprived petitioner

irretrievably of a state law *remedy* she otherwise would have had the opportunity to seek. *See Field v. Trump*, 850 F.2d 938, 948 (2d Cir. 1988) (requiring allegation of lost opportunity to prevent conduct causing irreparable injury), *cert. denied*, 489 U.S. 1012 (1989). Here, in contrast, Levitin cannot point to any remedy "lost" as a result of the alleged deception; on the contrary, her complaint explicitly alleges state law damages claims for the very conduct at issue.

Second, the purported deception on which any such hybrid state law/Section 10(b) claim would rest — PaineWebber's failure to disclose its retention of the customer's interest — is negated by the Second Circuit's holding that *there simply was no deception*; as a matter of law, the court ruled, no reasonable investor could fail to appreciate that "money has a time value" and "a brokerage can earn profits from funds deposited with it as security for short sale transactions." *Levitin II*, 159 F.3d at 702 (Pet. App. 8a). That ruling, fatal to petitioner's federal securities fraud claim in any of its guises, stands unchallenged by both petitioners.

In short, a different view of preemption would in no way alter the conclusion that Levitin was not deceived by PaineWebber's conduct, that she therefore has no federal securities law claim against PaineWebber, and that the pendent state law claims were properly dismissed by the district court for lack of subject matter jurisdiction. Where, as here, an opinion on preemption plainly would not affect the outcome of the action on remand, certiorari should not be granted. *See The Monrosa*, 359 U.S. at 181.

B. The U.C.C. § 9-207(2)(c) Claim in *Bissell* Fails on State Law Grounds.

In *Bissell*, petitioner has no state law claim at this juncture even if his claim is not preempted; the district court held, and the court of appeals concurred, that he had "otherwise agree[d]"

within the meaning of U.C.C. § 9-207(2)(c) when he negotiated an agreement with Merrill Lynch regarding the remittance of the earnings from his short sale collateral. Bissell thus contracted out of that provision. *See Bissell I*, 937 F. Supp. 237, 248-49 (Pet. App. 48a); *Bissell II*, 157 F.3d at 138-39 (Pet. App. 23a). Bissell does not seek review of that finding. Accordingly, whether or not federal regulation preempts U.C.C. § 9-207(2)(c) would have no effect on the outcome of *Bissell*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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No. 98-1013

IN THE
Supreme Court of the United States
OCTOBER TERM, 1998

RAIZY LEVITIN,

Petitioner,

vs.

PAINEWEBBER, INC.,

Respondent.

LOUIS G. BISSELL, JR.,

Petitioner,

vs.

MERRILL LYNCH & COMPANY, INC., and
MERRILL LYNCH PIERCE, FENNER & SMITH, INC.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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I.

The petition presents a single, straightforward legal question concerning federal preemption of state law:

> In holding that § 9-207(2)(c) of the UCC (of which identical versions have been enacted in all 50 states) was impliedly preempted by federal securities law, notwithstanding (i) the absence of any conflict between § 9-207(2)(c) and any specific provision of the federal securities laws, and (ii) the SEC's express pronouncement that it does not regulate payment of interest to customers on their collateral (as well as a similar pronouncement by the Federal Reserve Board), did the court below ignore the preemption principles established by this Court?

To this issue respondents' brief in opposition devotes four (pp. 10-13) scant pages. Those pages add nothing to the court of appeals' analysis, except adding the startling claim -- one not made by the court below -- that SEC policy *affirmatively* supports respondents retention of interest (pp. 12-13). That claim is made without even a single reference -- not one -- to petitioners' brief, and to the SEC's pronouncement that the issue of interest is to be determined by negotiation between the parties (Pet. App. p. 74a) .

As we demonstrated in the petition, no federal policy directs the allocation of interest between customers and brokers (If, however, such a federal policy did exist, that policy would be controlling). Existing federal policy leaves the matter of interest to the agreement of parties, and § 9-207(2)(c) provides a default rule in that respect. Like the court below, therefore, respondents cannot identify *any* conflict between state and

federal law. This is a crucial defect. The fundamental principle of our constitutional order, reflected in the Rules of Decision Act[1] and the decisions of this Court,[2] is that, absent displacement by a valid federal rule, state law governs.

II.

Rather than provide any additional support for the Second Circuit's preemption holding, respondents seek to persuade the Court that no federal issue of importance is "clearly" presented. Like anti-aircraft gunners, respondents' numerous arguments are thrown upward in the hope that one will hit that target. We examine these arguments briefly to show that they are devoid of merit, and that an important issue of "Our Federalism" has been clearly presented to this Court.

1. Respondents direct the Court's attention to"the facts and procedural history of each case, which are not set forth in the petition . . ." The relevance of their elaborate recitation (pp. 1-6) is nowhere made clear.[3] Nor can it be. In

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[1] 28 U.S.C. § 1652. "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the Courts of the United States, in cases where they apply."

[2] *Erie v. Thompkins*, 304 U.S. 64 (1938); *Hannah v. Plumer*, 380 U.S. 460 (1965).

[3] For example, there is a discussion of the difference between "short sales" and "short sales against the box", a difference that (continued...)

this litigation, many issues were resolved against petitioners in the courts below upon which they do not seek review. But the question on which they do seek review is distinct and clearly presented. Respondents' effort to depict this petition as raising only fact-dependent issues is without merit.

2. Respondents argue that certiorari should be denied because there is no circuit conflict. There is no direct conflict in a technical sense, and petitioners have never represented otherwise. But a conflict exists at a much deeper level between the decision below and *SEC v. Lehman Brothers, Inc.*, 157 F.3d 2 (1st Cir. 1998) in their fundamental approach to the relationship between the U.C.C. and federal securities law (Pet. 7-9). What is more, the decision is in (at best) considerable tension with this Court's holding that normally "interest follows principal," *Phillips v. Washington Legal Foundation*, 118 S. Ct. 1925, 1930 (1998), a decision that respondents seek to distinguish(p. 8) in a few unresponsive sentences.

3. Respondents point out that the court below referred to this Court's preemption cases, and then rely on Rule 10 for the proposition that "the misapplication of a properly stated rule of law" is "rarely" a ground for the granting of a writ. That language is concerned with the routine application of law to facts -- for example, decisions as to whether there had been an unreasonable search and seizure, or whether the defendant was "in custody" for purposes of the *Miranda* warnings. The language reflects the

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[3](...continued)
the court below said was immaterial for purposes of its holding (Pet. App. p. 23a).

fact that this Court is not a court of errors and appeals whose function includes correcting erroneous judgments. (When, however, the application of law to fact involves the need to further develop legal standards, review is readily granted.[4]) The quoted language has no pertinence whatsoever to issues of the character asserted here: the purely legal issue of whether federal law displaces state law in the absence of some kind of identifiable conflict between the two. This petition is governed by Rule 10(c) because "a United States court of appeals . . . has decided an important federal question in a way that conflicts with relevant decisions of this Court."

4. Finally, respondents attack the standing of petitioners to raise the preemption claims asserting that only an advisory opinion is sought. Their attack is wide of its mark. They insist that the court found that petitioner Bissell "agreed" to respondent's conduct; and then he "contracted out" of any § 9-207(2)(c) protection (*see* pp. 15-16). The court of appeals, in fact, made no such finding (See Pet. App. p. 23a). Had it done so, it would have had no occasion to discuss preemption. With respect to petitioner Levitin, it made no relevant finding at all. Whether or not petitioner Levitin's state law claim sufficiently implicated federal claims (*see* Opp. pp. 14-15), Levitin's state law claims under § 9-207(2)(c) are independent and thus remain open. Thus, with respect to both petitioners, the court concluded that their claims were pre-empted by federal law.

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[4] E.g., *Ornelas v. United States*, 517 U.S. 690, 695-697 (1996).

That determination, and that determination alone, is what this petition seeks to review.

Dated: New York, New York
February 2, 1999

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